DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR

FROM: Chief, Branch 2
(Employee Benefits & Exempt Organizations)

SUBJECT: Payments to Employees for the Use of

Legend:

X =

Issue

This is in response to your E Mail of concerning the proper treatment of payments an employer makes to its employees for use of the employees . In addition to your E Mail, you provided copies of materials from X, which we have enclosed. This response will discuss " " and then whether the arrangement by X is an accountable plan.

Conclusion

We cannot conclude that the same result will apply in every case. However, this memo suggests an analysis to follow in cases. The issue is whether the are wages for Federal employment tax purposes. If the are paid pursuant to an accountable plan, the payments are not wages for employment tax purposes. Thus, the issue that must be resolved in these cases is whether the arrangement is an accountable plan.

X

We understand that X is an entity that
X maintains

Based upon the information we have reviewed it is not clear whether X offers . As stated above, whether are wages subject to employment taxes depends upon whether they are paid pursuant to an accountable plan. We cannot opine on whether . However, we note that certain comments included in X's
and are not correct.

Facts

Your request is not case specific. We understand that in a typical arrangement the employer will pay an employee a small hourly wage, such as $8.00, and treat that amount as wages subject to employment taxes. The employer will also pay the employee an additional amount per hour, such as $24.00, to the employee's . The amount treated as wages will be reported to the employee on Form W-2, and the if reported, will be reported on Form 1099. We have assumed for purposes of this response, that the workers are employees.[1]

Law & Analysis

The three employment taxes are the Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) tax, and income tax withholding. The discussion herein is limited to whether, for employment tax purposes, the employer is properly treating amounts paid under the arrangement. This memorandum does not discuss how an employee should report payments not paid under an accountable plan that the employer does not treat as wages.[2]

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[1]In certain cases, worker classification may be an issue. To determine whether a worker is an employee or an independent contractor the common law test must be applied. See, IRS Publication 1976, Independent Contractor or Employee. If the analysis concludes that the workers are independent contractors, issues arise concerning the effect of converting workers to independent contractors, and Exam should contact the National Office.

[2]When an employer fails to characterize properly amounts paid to an employee as wages, issues arise concerning how the employee should report such payments and claim any related deductions.

I.R.C. § 62

As stated, the issue is whether the payments are wages for employment tax purposes. In general, wages are defined for FICA, FUTA and income tax withholding purposes as all remuneration for employment unless otherwise excluded. I.R.C. §§ 3121(a), 3306(b) and 3401(a). There is no statutory exception from wages for amounts paid by employers to employees for employee business expenses. However, Treas. reg. § 1.62-2(c)(4) provides that amounts an employer pays to an employee for employee business expenses under an "accountable plan" are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. Treas. reg. §§ 31.3121(a)-3, 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations, and Treas. reg. § 1.6041-3(h)(1) of the Income Tax Regulations.

Whether amounts are paid under an accountable plan is governed by I.R.C. § 62 which includes the provisions on employee reimbursement or other expense allowance arrangements. Section 62 generally defines "adjusted gross income" as gross income minus certain ("above-the-line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee, in connection with his or her performance of services as an employee, under a reimbursement or other expenses allowance arrangement with the employer. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of I.R.C. § 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement or (2) such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under section 1.62-2(c)(1) of the regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of I.R.C. § 62(c), if it meets the three requirements of business connection, substantiation, and returning amounts in excess of expenses, set forth in paragraphs (d), (e), and (f), respectively, of Treas. reg. § 1.62-2 ("the three requirements").

If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an "accountable plan." Treas. reg. § 1.62-2(c)(2)(i). The regulations further provide that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported

to the employee on Form W-2, and are subject to withholding and payment of employment taxes. Treas. Reg. §§ 1.62-2(c)(5), 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2) and 31.3401(a)-4(b)(2).[3]

An arrangement meets the business connection requirement of Treas. Reg. § 1.62-2(d) if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expense, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 through section 196), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee. Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur business expenses described in paragraphs (d)(1) or (d)(2).

Section 1.62-2(e) of the regulations provides that the substantiation requirement is met if the arrangement requires each business expense to be substantiated to the payor (the employer, its agent or a third party) within a reasonable period of time. As for the third requirement that amounts in excess of expenses must be returned to the payor, the general rule of Treas. reg. § 1.62-2(f) provides that this requirement is met if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated.

Section 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c)

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[3]Section 62(c) of the Code was enacted by the Family Support Act of 1988, Pub. L. 100-485. Through enactment of section 67 of the Code by section 132 of the Tax Reform Act of 1986, (1986 Act), Pub. L. 99-514, 1986-3 C.B. (vol 1) 30, the Congress sharpened the distinction between the tax treatment of unreimbursed and reimbursed employee business expenses. Among other changes, unreimbursed employee business expenses plus other miscellaneous itemized deductions generally were made subject to a two-percent floor. At the same time, the Congress decided to retain the above-the-line deduction treatment for reimbursements received by an employee pursuant to a reimbursement arrangement. This rationale for allowing the employee an above-the-line deduction to offset true reimbursement amounts does not apply in the case of nonaccountable plans. Under these plans, the amount received by the employee from the employer is not determined by the actual amount of expenses incurred by the employee during the year.

and the regulation sections, all payments made under the arrangement will be treated as made under a nonaccountable plan.

Revenue Ruling 68-624

Employers typically rely on Rev. Rul. 68-624, 1968-2 C.B. 424 as authority for designating a portion of an employee's compensation as a rental payment and excluding that amount from wages. The question raised in Rev. Rul. 68-624, is what percentage of the total amount paid by a corporation for the use of a truck and the services of a driver is allocable as wages of the driver for FICA purposes. The facts specify that the corporation hires a truck and driver to haul stone from its quarry to its river loading dock at a fixed amount per load and allocates one-third of the amount paid the employee as wages and two-thirds as payment for the use of the truck. The ruling holds that an allocation of the amount paid to an individual when the payment is for both personal services and the use of equipment must be governed by the facts in each case. If the contract of employment does not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation may be arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment.

Although Rev. Rul. 68-624, has not been obsoleted, we believe it should not be relied upon to exclude payments for from wages. The analysis in Rev. Rul 68-624 is incomplete under current law because it does not consider whether the are paid under an accountable plan. Under current law, the can be excluded from wages only if they are paid under an accountable plan. An employment contract that merely allocates compensation between wages and will not satisfy the requirements of I.R.C. § 62(c). To exclude employee reimbursements or other expense allowance payments from wages an employer must establish an accountable plan.

Case Law

The Service has not issued any private letter rulings or technical advice memoranda that address whether payments are wages. In addition, to our knowledge no case has considered the issue. However, two recent cases Trans-Box Systems v. United States, No. C-97-2768 THE, 1998 U.S. Dist. LEXIS 3560 (N.D. Cal. August 28, 1998,) (*appeal pending* 9th Cir.), and Welch v. Commissioner, T.C. Memo 1998-310 are helpful in analyzing the issue.

Trans-Box, a courier service, paid its courier drivers, who used their own cars to make deliveries, $8.95 per hour. Trans-Box treated 45% of the $8.95 as

wages subject to employment taxes and treated the remaining 55% as either lease payments or vehicle expenses. The government assessed employment taxes on the entire $8.95. In opposing the government's motion for summary judgment, Trans-Box's primary position was that the automobile lease payments or vehicle expenses were paid under an accountable plan and were exempt from employment taxes. Trans-Box asserted that it had substantially complied with the accountable plan requirements in I.R.C. § 62 citing American Air Filter Co., Inc. v. Commissioner, 81 T.C. 709 (1983).

Trans-Box raised two alternative arguments. First, it argued the drivers were independent contractors rather than employees for purposes of the automobile lease payments and thus, not subject to I.R.C. § 62. Second, Trans-Box argued that it was entitled to relief under Section 530 of the Revenue Act of 1978. The government argued that Trans-Box had treated the drivers as employees for all purposes and the arrangement Trans-Box established was not an accountable plan because the drivers were not required to substantiate their expenses or return any amounts received that exceeded their expenses.[4]

The court concluded that Trans-Box failed to created a triable issue of fact regarding whether the drivers were, at least for some purposes, independent contractors. The court noted that the facts in the record point to the conclusion that Trans-Box had treated the owner-operators as employees for all purposes. It had paid the drivers hourly wages, reported those on Form W-2 and not filed any Forms 1099 for the automobile payments.

The court pointed out that Trans-Box's primary argument was that the drivers were employees for all purposes and that it substantially complied with the requirements of I.R.C. § 62(c). While acknowledging that Trans-Box was free to argue alternative or conflicting legal arguments the court stated "serious questions about the veracity of its allegations are raised because Trans-Box's alternative argument relies upon conflicting versions of the material facts at issue." Trans-Box Systems v. United States, 1998 U.S. Dist. Lexis *10-11. Thus, the court granted the government's motion for summary judgment on the plaintiff's claims and summary judgment on the government's counterclaim for recovery of unpaid employment taxes. The court did not address the Section 530 argument.

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[4]Although not asserted by the government, Trans-Box also did not satisfy the business connection requirement. Treas. reg. 1.62-2(d)(3)(i) provides that the business connection is not satisfied if a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses.

Although the court's decision rests on Trans-Box's failure to create a triable issue of fact on worker classification, the decision is significant because the court refused to apply a substantial compliance rule to I.R.C. § 62(c) or to allow Trans-Box to argue different versions of the facts.

In Welch v. Commissioner, T.C. Memo 1998-310 the Tax Court held that Mr. Welch's equipment leasing activities in 1993 were not passive activities. Mr. Welch, a carpenter, was hired by movie production companies as a construction coordinator. Mr. Welch and the production company would enter into a "deal memorandum" setting forth the terms of his employment including the rate that he would be paid and the rate at which he rented his equipment to the company. Typically, an inventory of his tools and equipment would be attached to the deal memo. The production company would report Mr. Welch's wages on a Form W-2 and the tool rentals on a Form 1099. As construction coordinator, he constructed movie sets, hired employees, arranged for the purchase of materials and furnished all the required tools. He was required to purchase, maintain, transport and repair the tools as needed. The facts also specify that in 1993, Mr. Welch rented tools to a third party for $1,500.00 for a project for which he was not the construction coordinator.

The court analyzed whether Mr. Welch's rental activity was a rental activity for purposes of I.R.C. § 469 and concluded it was not because he provided equipment to production companies for an average period of 30 days or less and he performed significant personal services in connection with making the property available for use by customers. The court noted that he acquired, maintained, transported and repaired the tools and equipment. The court concluded that Mr. Welch provided extraordinary personal services and the rental of the tools and equipment by the production companies was incidental to receipt of Mr. Welch's services as a construction coordinator. The court further held that Mr. Welch materially participated in his business as a construction coordinator and therefore, was not subject to the loss limitations imposed by I.R.C. § 469.

Although the Tax Court was not required to decide whether the rental arrangement was an accountable plan within the meaning of I.R.C. § 62(c) or whether Mr. Welch was an employee or independent contractor, the facts illustrate an arrangement for the rental of equipment that was an arms length transaction memorialized in a writing. Perhaps the most significant fact is that Mr. Welch actually rented his tools to a third party that did not also employ him as the construction coordinator. Thus, at least in that instance his rental activity was separate from the services he performed as an employee.

Case Development, Hazards, and Other Considerations

It is our view that the best approach to address the issue is to go forward with a well developed case. Accordingly, we make the following suggestions for case development. Analyzing whether a arrangement is an accountable plan requires factual development, including an understanding of the details of the arrangement. It may not be assumed that every is a disguised payment of wages or that an employer cannot establish a arrangement that satisfies the accountable plan requirements.

An important fact to ascertain is when did the employer begin compensating its employees in part with a . Did the employer pay prior to the enactment of the Tax Reform Act of 1986 or the Family Support Act of 1988? It is also important to ask the employer why it decided to pay a , and whether the employer had motivations other than reducing its employment taxes.

It is also important to find out whether the arrangement is written. There may be a lease or the arrangement may be described in an employee handbook. Any writing should be evaluated to determine whether it reflects an arms length transaction and whether it specifies the employer's basis for allocating amounts between wages and rentals. Employers will likely maintain that the reflects the fair market value of the Thus, it is important to ask how the employer determined that amount. If there is a lease, factors to develop include whether the lease has a specific term and what happens if the employee terminates employment before the end of the lease term?

Even when there is a writing, it remains important to interview workers and find out their understanding of the arrangement and whether the specified terms of the arrangement are actually followed. For, example, the written arrangement or the employer may specify that employees must agree to let other employees use their . However, if another employee never actually uses the the requirement is meaningless. If the arrangement is unwritten, that is an important fact. Other factors to consider include whether employees must supply , are the left at the work site; are the maintained and insured and if so, who bears those costs. How the arrangement fits within the decisions in Welch and Trans-Box, should also be considered.

X.

We have reviewed the . The most important fact to know is that IRS has not ruled on the validity of

arrangement, and is incorrect. We also have not ruled that an employer may reduce liability for employment taxes by recharacterizing wages as . In addition, the private letter ruling program does not allow the IRS to rule on whether commercial products marketed and sold to the public comply with the provisions of the Internal Revenue Code. If a taxpayer purchased X's services and submitted a request for a private letter ruling on whether it had established an accountable plan, we might be able to issue a ruling, provided all other requirements of Revenue Procedure 99-1 were met.[5] Finally, if a taxpayer that is merely a factor to consider in determining whether the taxpayer's arrangement is valid. does not necessarily mean that the arrangement is accountable.

If you have questions, please call me at (202) 622-6040.

JERRY E. HOLMES

[5] specify that rental income is not subject to SECA tax and that is incorrect. I.R.C. § 1402(a)(1) excludes rentals from real estate from the definition of net earnings from self-employment. The statute, however, does not exclude other rental income. See, Stevenson v. Commissioner, T.C. Memo 1989-357.