CCA 1996-13

Equipment Rental Payments

This memorandum is in response to your September 27, 1995, request that we review the draft of your response to the March 30, 1995, memorandum from Joe Bruchis, Houma POD, concerning the proper income tax treatment of certain "rental" payments that are reported to taxpayers on Form 1099.

Mr. Bruchis' memorandum considers an issue that is arising frequently in examination concerning individuals who own and operate trucking vehicles, school buses and welding equipment. These individuals supposedly rent their equipment to their employer and then use it to perform services as an employee. In all three instances the employer gives the individuals both a Form W-2 and a Form 1099. In general, the amount reported on the Form W-2 as wages is a specified percentage of the employee's wages, and the amount reported on the Form 1099 is the percentage that the employer considered to be a rental payment. Mr. Burchis would like to be able to resolve all cases that involve a "rental" payment on a consistent basis. 1

The March 30, 1995 memorandum indicates that it has been the position of the Service to reclassify the amount reported on the 1099 as income earned in a trade or business reportable on Schedule C and subject to Self Employment Contributions Act (SECA) tax. Taxpayers and preparers are challenging this reclassification and contending that the income reported on Form 1099 is solely for the lease of the equipment and should be reported on Schedule E. Income reported on Schedule E is not subject to SECA tax. The preparers cite regulations under section 469 to support the proposition that rental of the equipment is a "rental activity" that should be reported on Schedule E.

Notwithstanding the preparers' objections, the March 30th, memorandum concludes that the circumstances suggest that the activities appear to be a trade or business activity engaged in for profit by the taxpayers.

We recognize that the field would like to resolve these cases consistently; however, it is not possible to conclude with certainty that every time an employer treats a portion of an employee's earnings as rent that the portion treated as rent is self-employment income. That determination is fact specific and requires an inquiry into the facts of each case. An analysis of the arrangement may reveal that the payments were intended as additional employee compensation or a reimbursement for employee business expenses. We note also that in considering these cases, the analysis can be unduly influenced by whether the taxpayer under audit is the employee or employer.

The reply prepared for Mr. Burchis was based on a memo drafted by this office in February, 1995 that related to the treatment of certain rig welders. As you discussed with Ms. Marie Cashman of this office, we have continued to examine the issues relating to rental payments over

the last year. As a result of our additional research and the number of calls we have received from the field, we have prepared the attached Memorandum which discusses the issues more generally and offers some suggestions on how to treat such cases. We suggest that this Memorandum be provided to Mr. Burchis.

As Ms. Cashman also advised you, we would like to see a well developed case submitted on a Request for Technical Advice. Then we would have the opportunity to examine an actual case and issue a Technical Advice that would formally address the issues in these cases.

We hope the attached Memorandum responds to your concerns. If you have any questions, please contact me or Ms. Cashman at (202) 622-6040.

JERRY E. HOLMES

MEMORANDUM

Allocation of Employee's Earnings

This memorandum considers whether it is appropriate to allocate an employee's earnings between wages and rent and how an employee whose earnings are so allocated should report the amount reported on Form 1099 as a rental payment.

BACKGROUND

It is common practice in various industries for employers to allocate employees' earnings between wages and a "rental" payment that is ostensibly paid by the employer to the employee to "rent" the equipment that the employee owns and uses at work. Generally, the employee must provide the equipment as a condition of employment.

Employers have a significant tax incentive to treat a portion of an employee's earnings as other than wages because it allows employers to reduce their Federal employment taxes. Federal employment taxes are the taxes imposed under the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and income tax withholding. The term wages is defined for Federal employment tax purposes in sections 3121(a), 3306(b), and 3401(a) of the Internal Revenue Code (the Code) respectively, as all remuneration paid to an employee for services rendered by an employee for his employer. Amounts that are not wages are not subject to Federal employment taxes. When an employer has designated a portion of an employee's earnings as rent, the employer will give the employee a Form W-2 reporting an amount of wages and a Form 1099 reporting the amount designated as rent for the use of the employee's equipment, as non employee compensation. If the employee reports the amount on the Form 1099, he will generally report it on Schedule E.

When an employer is under examination for this issue, it will often raise Rev. Rul. 68-624, 68-2 C.B. 424, as authority for designating a portion of the employee's salary as rent. The question presented 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 employment tax purposes. The facts involve a corporation that 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 to 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 where the payment is for both personal services and the 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 officially, we believe that relying on its holding to allocate a portion of an employee's wages is misplaced because it was overruled by the enactment of section 62(c) of the Code. The ruling no longer reflects current law. Further, even if the ruling were relied on it specifies that each case must be governed by its facts. In addition, although the ruling holds that the amounts paid to the driver for the use of his equipment are not wages, it does not consider how the driver is to treat such amounts for income tax purposes. Clearly, it was not the intent of the ruling for the driver to receive such amounts on a tax free basis. The amounts are income to the driver.

Thus, the primary issue to resolve when an employer treats a portion of an employee's earnings as something other than wages is what does the designated portion represent? A taxpayer may not determine the nature of his income merely by using a particular form, or by labeling it as he wishes, but must report his income based on the economic realities of the situation. See Frank Lyon Co. V. United States, 435 U.S. 561 (1978); Upham v. Commissioner, 923 F.2d 1328, 1335 (8th Cir. 1991), affg. T.C.M. 1989-253. In the case of a purported rental payment, there are three alternatives. The payment may be an actual payment of rent, a reimbursement of employee business expenses, or additional compensation for employment. It is only after determining what the payment is that its proper tax treatment can be determined.

DISCUSSION

To determine what the payment represents requires an analysis of the specific facts of the case including details of the rental arrangement. Factors to consider include the following: what is the equipment being rented - is it a tool such as a chain saw or is it a piece of heavy equipment such as a truck; does the employee have a significant investment in the equipment or is it replaced on a regular basis; is the rental agreement or the allocation agreement in writing; is there an actual lease for the equipment; must the employee provide the equipment as a condition of employment; is the employee who owns the equipment the only one permitted to use the equipment; is the equipment left at the job site; can the employee use the equipment to perform services for other employers; does the rent paid bear a relationship to the fair rental value of the equipment; is the rent intended to be a reimbursement for employee business expenses such as in the case of saw rent; if so, does the amount paid reflect the actual expenses incurred by the employee; is there any indication that the employer actually owns the equipment; and is the rental amount still paid when the employee is sick or on vacation or when the equipment is not at the job site. These factors are not exclusive and are intended as a starting point in the analysis. Other factors may be more relevant depending on the specific case.

The tax treatment of the rental payments may depend upon the type of equipment the employee is furnishing. One of the differences between tools and heavy equipment is that an owner will have a significant financial investment in heavy equipment.

If an employee is providing his own tools, the rental payments are likely intended as reimbursements for employee business expenses, which must be paid pursuant to an "accountable plan," as defined in section 62(c) of the Code in order to be excluded from wages. On the other hand, when an employee supplies a piece of heavy equipment, the individual may be engaged in the trade or business of renting his heavy equipment while concurrently performing services for the employer.

REIMBURSEMENTS FOR EMPLOYEE BUSINESS EXPENSES

If the analysis of the case results in the conclusion that the amounts designated as rentals were intended as reimbursements for employee business expenses, the arrangement must be tested under the requirements of section 62(c) of the Code to determine whether the amounts are excludable from the employee's income. When an employer establishes a reimbursement or other expense allowance arrangement to pay employee business expenses, the arrangement must satisfy section 62(c) of the Code or the amounts paid will be treated as wages. If the arrangement is an "accountable plan", as described in section 62(c), the amounts received are not included in gross income and are not subject to FICA and FUTA taxes or income tax withholding.

Employee reimbursement or other expense allowance arrangements are governed by section 62 of the Code. 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 his or her employer.

Section 62(c) of the Code provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 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.

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 an arrangement that does not satisfy section 62(c). Under these arrangements, which are called nonaccountable 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.

Under section 1.62-2(c)(1) of the regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) of the Code, 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 section 1.62-2 ("the three requirements").

If an arrangement meets the three requirements, section 1.62-2(c)(2)(i) of the regulations provides that all amounts paid under the arrangement are treated as paid under an "accountable plan." Under section 1.62-2(c)(4), amounts treated as paid 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. See sections 31.3121(a)-3, 31.3306(b)-2, 31.3401(a)-4 of the Employment Tax Regulations, and section 1.6041-3(i) of the Income Tax Regulations.

On the other hand, section 1.62-2(c)(3)(i) of the regulations provides that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are treated as paid under a "nonaccountable plan." Amounts treated as 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. See section 1.62-2(c)(5) of the Income Tax Regulations and sections 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2) and 31.3401(a)-4(b)(2) of the Employment Tax Regulations.

An arrangement meets the business connection requirement of section 1.62-2(d) of the regulations if it provides advances, 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 section 1.62-2(f) of the regulations 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. If an arrangement is a true reimbursement arrangement, this requirement will not be relevant as there is no excess to return.

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

When an employer merely designates a certain amount of an employee's earnings as reimbursements for business expenses, the arrangement will not satisfy section 62(c) of the Code. First, the arrangement fails the business connection requirement because the employer is paying an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur the expense. Normally, the portion designated as a reimbursement bears no

relationship to the expenses incurred. See Technical Advice Memorandum 9504002 which considers a mileage reimbursement arrangement that fails section 62(c). A designation arrangement will also fail the substantiation requirement as there is no substantiation required. Thus, the arrangement will be treated as a nonaccountable plan described in section 1.62-2(k) and ALL amounts paid under that arrangement are wages that must be reported on Form W-2 and are subject to employment taxes. It is incorrect to report such amounts of Form 1099. The employees must report such amounts as wages, and any allowable deductions can be taken as miscellaneous deductions on Schedule A.

TRADE OR BUSINESS INCOME

When an employee provides a piece of heavy equipment for use on the job the appropriate inquiry is whether the employee is engaged in the trade or business of renting the equipment to his employer. 1 If the individual is engaged in a trade or business, the rental income is self-employment income that should be reported on Schedule C and any net earnings from self-employment income should be reported on Schedule SE subject to SECA tax.

Section 1401 of the Code imposes SECA taxes on the self-employment income of every individual. Section 1402(b) provides generally that "self-employment income" means the net earnings from self-employment derived by an individual during any taxable year, subject to the exception for amounts in excess of the contribution base for the year.

Section 1402(a) of the Code provides that "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, subject to certain specific exceptions.

Section 1402(c) of the Code provides that "trade or business" when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), with certain specific exceptions.

In Higgins v. Commissioner, 312 U.S. 212 (1941) and Commissioner v. Groetzinger, 480 U.S. 23 (1987), the United States Supreme Court held that resolving the issue of whether a taxpayer is engaged in a trade or business for purposes of the Code "requires an examination of the facts in each case." 312 U.S. at 217. As summarized in Groetzinger, Higgins holds that "full-time market activity in managing and preserving one's own estate is not embraced within the phrase 'carrying on a business' and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business." 480 U.S. at 31-32. Groetzinger held that a full-time gambler who made wagers for his own account was engaged in a "trade or business" for purposes of the Code.

While Groetzinger does not provide a specific test for what constitutes a trade or business, the Court did set forth several principles that are applicable in such a determination.

Of course, not every income producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with . . . business or trade, " on the other. . . . We accept the fact that to be engaged in a trade or business,

the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

480 U.S. at 35.

Applying the principles the Supreme Court set forth in Groetzinger, an employee who rents his heavy equipment to his employer can be engaged in a trade or business if he is involved in the activity of renting the equipment with continuity and regularity. Arguably, if the heavy equipment is rented to the employer every day and it cannot be used for personal use, the owner's primary purpose in investing in and renting the heavy equipment is to make a profit.

There is nothing in the Code that prevents individuals from concurrently being employees and independent contractors. In general, section 1402(c)(2) excepts from the term "trade or business" when used with reference to an individual's net earnings from self-employment, the performance of service by an individual as an employee. Section 1402(d) provides that the term employee has the same meaning as it does when used under the FICA. Section 3121(d)(2) provides that the term employee includes any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

Thus, when an individual performs services for his employer that individual is an employee for FICA purposes with respect to such service. However, when an individual is also in the trade or business of renting equipment to the employer the act of renting the equipment to the employer is not the performance of services as an employee. The equipment owner is engaged in a trade or business separate and apart from the performance of service as an employee. Therefore, the owner is engaged in a trade or business for SECA purposes. Thus the rental payments are not treated as wages. The rental payments must be reported to the employee on a Form 1099, and the individual must report them on Schedule C, not Schedule E. The net earnings from self-employment are then subject to SECA tax.

There is nothing in the Code or regulations that exempts income from the rental of equipment from SECA tax. Section 1402(a)(1) of the Code excludes from net earnings from self-employment rentals from real estate and from personal property leased with real estate. The rental exemption was addressed by the Tax Court in Stevenson v. Commissioner, T.C.M. 1989-357. There the taxpayer operated a business in which he sold and rented portable advertising signs. Taxpayer contended that the rental exclusion in section 1402(a)(1) exempted him from liability for self-employment tax. The Tax Court held that the concept of net earnings from self-employment used in section 1402(a) provides the standard not only for liability for SECA tax but also for Social Security Benefits. The Court then observed that in order to achieve the Congressional policy of insuring that the optimum number of potentially eligible persons will be provided for under the Social Security provisions, exceptions from the tax are to be narrowly construed. In its discussion the court cited Delno v. Celebrezze, 347 F. 2d 159 (9th Cir.), which involved the parallel provision to section 1402(a) in the Social Security Act, and in which the Ninth Circuit discussed the legislative history accompanying the rental exception. The Committee reports accompanying the bill enacting the rental exception make it clear that not all payments which might be considered rent in the ordinary parlance are to be excluded from self-employment net income. In Stevenson, the court held that the taxpayer was subject to SECA tax

on the income from his portable sign rentals. Thus, it is clear that the rental exception in section 1402(a)(1) is to be narrowly construed and does not apply to the rental of equipment.

When the Service attempts to reclassify a taxpayer's rental income as income from a trade or business, some taxpayers have argued that the rental activity is a passive rental activity as defined in section 469 of the Code and as such should not be subject to SECA tax. In other words, if a taxpayer is engaged in a passive activity, the taxpayer is not engaged in a trade or business for self-employment tax purposes.

This analysis is incorrect. It ignores the purposes of both sections and fails to recognize that the relationship between sections 1402 and 469 is much more subtle. Section 469 determines whether particular items of deduction are disallowed as passive activity deductions for a tax year. The appropriate analysis for determining whether a taxpayer has self-employment income is the trade or business analysis described above.

Section 1.469-1T(d)(3) provides that a deduction that is disallowed for a tax year under section 469 and its regulations is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Code. The following example illustrates:

Example: An individual has a $5,000 passive activity loss for a taxable year all of which is disallowed. All of the disallowed loss is allocated to activities that are trade or businesses within the meaning of section 1402(c). Such LOSS IS NOT TAKEN into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. In addition, . . . such loss is not taken into account for the taxable year in commuting the taxpayer's net earnings from self-employment subject to tax under section 1401.

Thus, it is clear that the regulations under section 469 contemplate that a taxpayer may be engaged in a trade or business for purposes of section 1402 and that trade or business can be passive for purposes of section 469. Thus, to the extent a taxpayer's losses are disallowed by section 469 those losses may not be taken when calculating net earnings from self-employment. This treatment conforms with the general rule in section 1402(a) which provides that net earnings from self employment means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business.

REMUNERATION FOR EMPLOYMENT

After analyzing the facts of a case it may be clear that the designated rental payments are not true rental payments nor are they reimbursements for employee business expenses. In that case the payments are additional employee compensation that are treated as wages for Federal employment tax purposes.

When the employee is under examination this would result in moving any deductions taken on Schedule E or C and treating them as miscellaneous itemized deductions deductible on Schedule A.

CONCLUSION

Whenever a portion of an employee's wages is designated as rent, the specific facts of the case must be analyzed to determine exactly what the designated payment is for. Because this issue is arising with regularity we would welcome the opportunity to consider a well developed case on a request for technical advise. If you have a specific case involving the issues discussed herein, please call Ms. Marie Cashman of my staff at (202) 622-6040 so that we can discuss the specific facts and determine how the foregoing analysis would apply.

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JERRY HOLMES

Chief, Branch 2

Office of the Associate

Chief Counsel

(Employee Benefits and

Exempt Organizations)

1 On December 9, 1993, this office provided a Field Service Advice to District Counsel, New Orleans that concluded that amounts paid to a parish school bus driver for bus operating expenses were wages includible on a Form W-2. We have reviewed that response and have concluded that we would reach the same conclusion based on the facts presented in that request.