OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Chief, Branch 2 (Employee Benefits and Exempt Organizations)
CC:EBEO:2

SUBJECT: Welding and Oilfield Workers

This Field Service Advice responds to your request of July 30, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUE

Whether Amounts Paid to Employees as Rig Rentals are Wages for Federal Employment Tax Purposes?

CONCLUSION

Whether rig rentals are wages depends upon whether the rentals are paid pursuant to an accountable plan. If so paid, the payments are not wages for employment tax purposes. Thus, the issue that must be resolved based upon the facts and circumstances of each case is whether the rig rentals are paid pursuant to an accountable plan.

FACTS

On July 30, 1998 your office submitted a request for Technical Advice with respect to rig rental payments. Under separate cover we advised that we were unable to process the request for Technical Advice because the requirements of Revenue Procedure 1998-1 I.R.B. 74 were not met. In particular, the facts

provided were not case specific. Accordingly we closed the request for Technical Advice and opened a Field Service Advice. Discussions with the Revenue Agent who prepared the request confirmed that Examination is seeking general advice on handling similar cases involving rig rentals. Thus, we provide the following advice.

We understand that there are many similar cases, and we recognize that Examination would like the same conclusion to apply to all cases. However, as explained herein, determining whether the rig rentals are paid pursuant to an accountable plan requires performing a factual analysis of the specific facts of each case.

Generally, an employer engaged in the business of specialized industrial construction will hire employee rig welders. Welders are highly skilled and when hired to perform welding services that is the only function they perform at the job site. They provide all of their own equipment, which generally includes a truck, welder, welding tanks and related items. On a non-union job, welders are required to provide all their own welding supplies. On a union job supplies are generally provided by the employer.

Typically, employers compensate the welders by paying them an hourly wage of about $10.00 per hour, which is treated as wages subject to employment taxes. The employer will also pay the welder an additional amount per hour, such as $20.00 to rent the employee's welding equipment. This payment is commonly referred to as a rig rental. The welder is paid at the end of each week when he turns in his "rig ticket" which reports the hours worked each day, but does not indicate the expenses the welder incurred associated with his equipment. Thus, the amount of rig rental is based solely on hours worked and has no apparent relationship to expenses incurred. The employer issues the employee two checks, one for wages and one for rig rentals. The amount treated as wages will be reported to the employee on Form W-2, and the rig rental, if reported, will be reported on Form 1099.

Law & Analysis

I.R.C. § 62

As stated, the issue is whether the rig rentals are wages for employment tax purposes. The three Federal employment taxes are the Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) tax, and income tax withholding. 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 expense 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 the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement or gives the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under Treas. reg. § 1.62-2(c)(1), 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).[1]

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[1]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

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) 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

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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 an above-the-line deduction to offset true reimbursement amounts does not apply in the case of nonaccountable plans. Under 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.

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 rental payments for equipment from wages. The analysis in Rev. Rul 68-624 is incomplete under current law because it does not consider whether the rental payments are paid under an accountable plan. Under current law, the rental payments can be excluded from wages only if they are paid under an accountable plan. An employment contract that merely allocates compensation between wages and rentals 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

Research has not revealed any private letter rulings or technical advice memoranda concerning whether rig rentals are wages for employment tax purposes. In addition, to our knowledge, no case has considered this specific issue.[2] 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,), and Welch v. Commissioner, T.C. Memo 1998-310 are helpful in analyzing the rig rental 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 expense payments. 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

[2]In Baker v. Barnard Construction Co., Inc., 1994 WL 371558 (D.N.M.) rig welders prevailed on a summary judgment motion that they were employees for purposes of the Fair Labor Standards Act. Although this decision is not relevant for tax purposes, it is interesting that the facts specify that the litigating rig welders filed as independent contractors for tax purposes.

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.[3]

The court concluded that Trans-Box failed to create 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.3 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. Although this decision rests on Trans-Box's failure to create a triable issue of fact on worker classification, it 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

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[3]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.

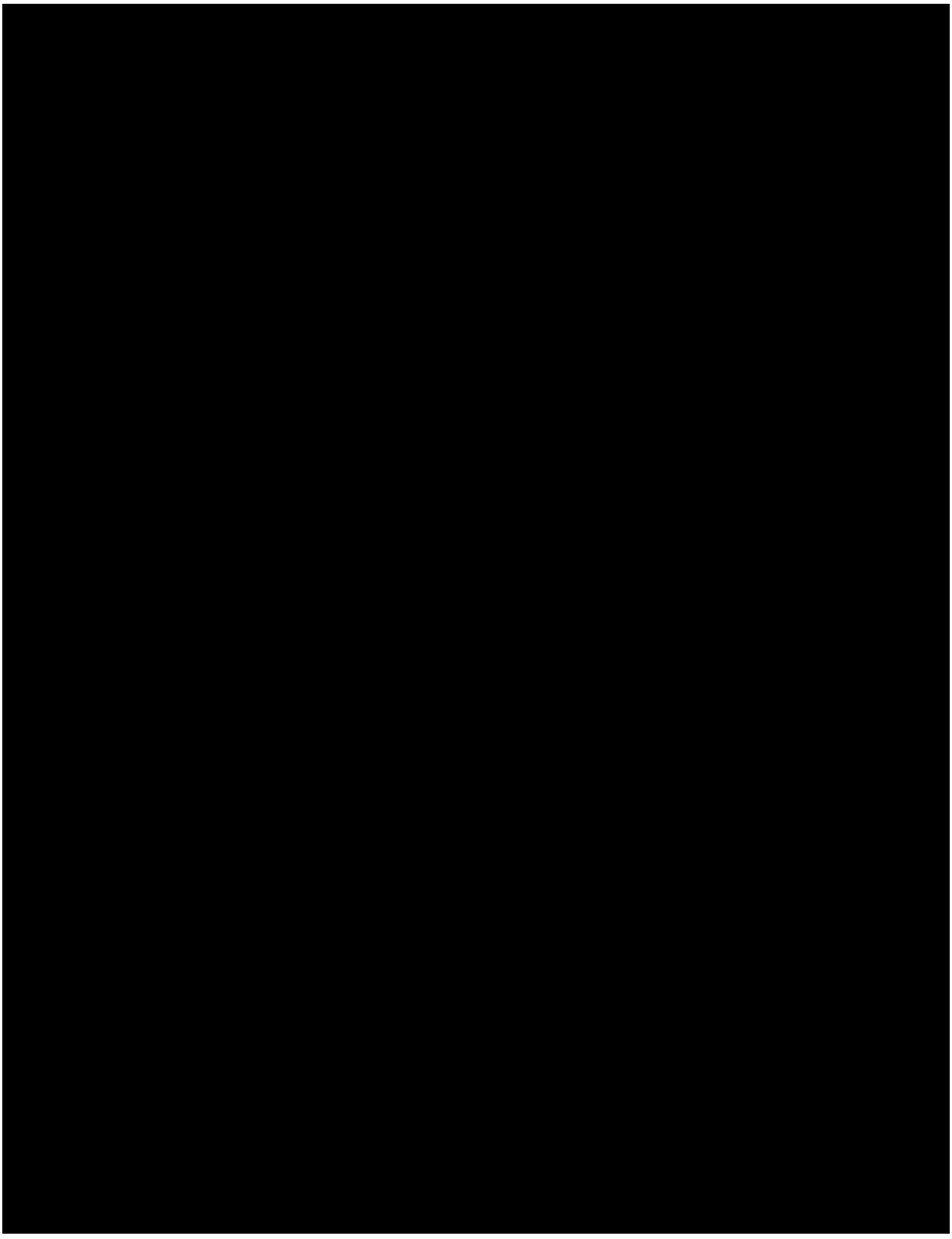
coordinator. Mr. Welch and the production company would enter into a "deal memorandum" setting forth the terms of his employment including the rate that he would be paid and the rate at which he rented his equipment to the company. Typically, an inventory of his tools and equipment would be attached 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.

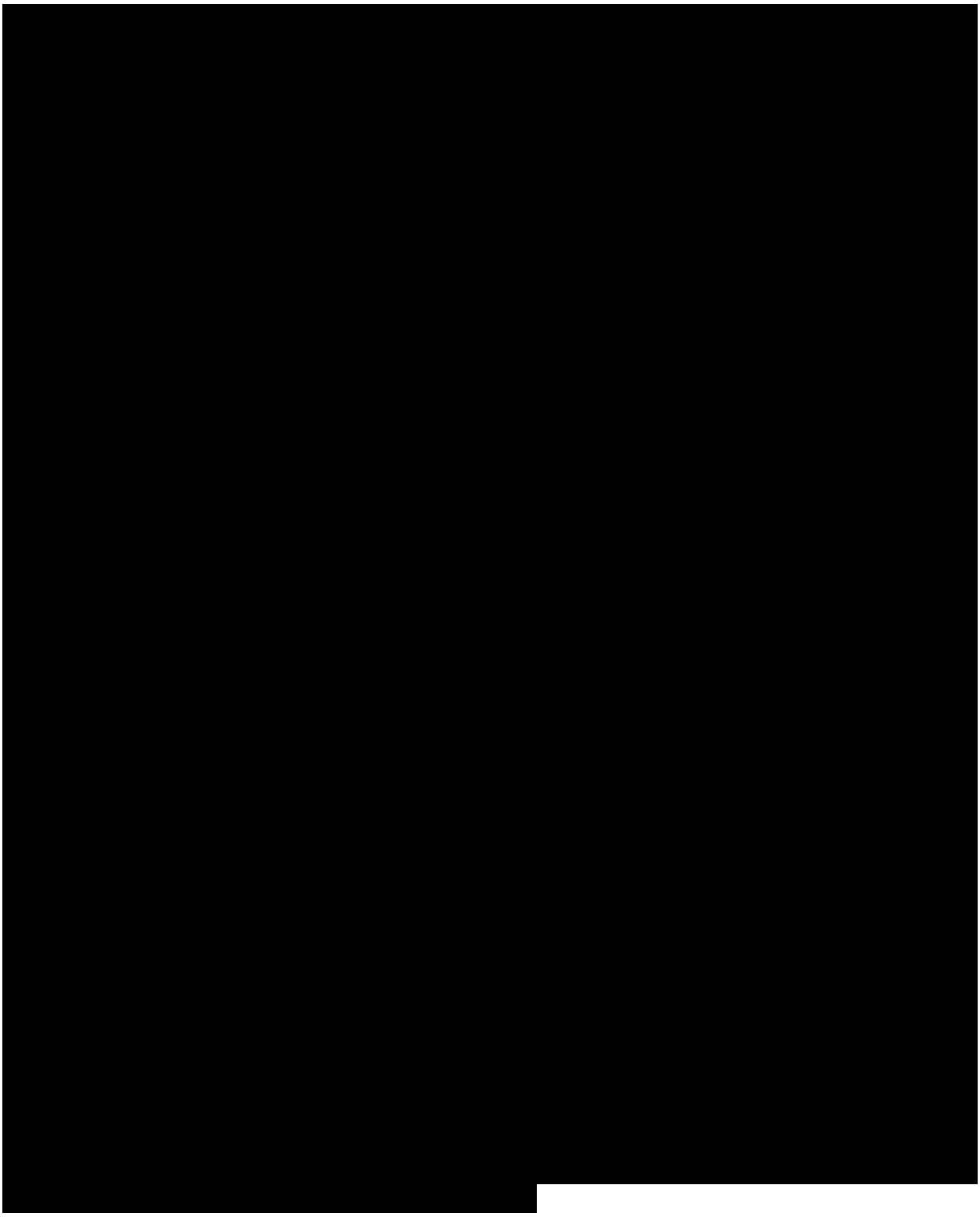
The court analyzed whether Mr. Welch's rental activity was a rental activity for purposes of I.R.C. § 469 and concluded it was not because he provided equipment to production companies for an average period of 30 days or less and he performed significant personal services in connection with making the 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 rig rental issue [redacted]





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

JERRY E. HOLMES