Part I

Section 62. Adjusted Gross Income Defined
(Also §§ 3121(a), 3306(b), 3401(a), 7805(b).)

26 CFR 1.62-2: Reimbursements and other expense allowance arrangements.
(Also §§ 31.3121(a), 31.3306(b), 31.3401(a), 301.7805-1.)

Rev. Rul. 2002-35

ISSUE

Whether amounts paid to employees for employee-provided equipment, including vehicles, that are used by the employee to provide services as an employee are wages subject to federal employment taxes?

FACTS

Situation 1 – Business A is engaged in pipeline construction and repair. A hires welder B and heavy equipment mechanic C to perform services as employees in connection with the construction of a pipeline. Business A requires B to provide and maintain a welding rig for B's use in providing welding services and requires C to provide and maintain a mechanics rig for C's use in performing repair and maintenance services at the work site on the employer's heavy equipment. B and C are required to provide rigs sufficient to perform the required employee services. (Neither employee B nor C is an independent contractor.)

A welding rig consists of a truck equipped with a welding machine and other specialized welding equipment required to perform welding services. B is paid an hourly wage of $X for the performance of services as an employee. In addition, A pays B an hourly amount of $Y per hour for providing the welding rig. This rig reimbursement is only paid for those hours that B performs services as A's employee.

A mechanics rig consists of a heavy truck equipped with a crane, welding machine, and various other equipment used in the repair of heavy construction equipment. C is paid an hourly wage of $X for the performance of services as an employee. In addition A pays C an additional $Y amount per day for providing the mechanics rig. This rig reimbursement is only paid for the days that C performs services as A's employee.

Business A requires B and C to each execute a document specifying that the employee owns the rig provided and will insure and maintain the rig. Employees B and C bear all expenses associated with the operation and maintenance of their respective rigs. The flat dollar amount paid as rig reimbursement is not related to the actual employee business expenses B or C incurs while performing services as an employee of A. Business A does not require B or C to substantiate expenses incurred related to the rig provided. Nor does A require B or C to return any amount paid as a rig reimbursement that exceeds the actual employee business expenses B or C incurs in connection with providing a rig while performing services as an employee of A.

Situation 2 – Business A also hires laborer D to perform services as an employee. Employee D uses D's pickup truck for transportation along the pipeline. Employee D is paid an hourly wage of $X for the performance of services as an employee and is also paid an additional amount of $Y per day for providing the pickup truck. Business A does not require D to substantiate mileage or actual employee business expenses incurred while performing services as an employee of A. Employee D is not required to return any of the daily amounts paid for the pickup truck if the amount paid exceeds the employee business expenses D incurred in connection with the pickup truck while performing services as an employee of A. (Laborer D is not an independent contractor.)

LAW AND ANALYSIS

Section 3402(a) of the Internal Revenue Code (Code) requires employers paying wages to deduct and withhold income tax on wages. For income tax withholding purposes, § 3401(a) provides that the term "wages," with certain exceptions, means all

remuneration for services performed by an employee for an employer. Under §§ 3111 and 3301, Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax, respectively, excise taxes are imposed on the employer in an amount equal to a percentage of the wages paid by that employer. Under § 3101, FICA tax also is imposed on the employee. Under §§ 3121(a) and 3306(b), the term "wages" for FICA tax purposes and FUTA tax purposes, respectively, means, with certain exceptions, all remuneration for employment. Under §§ 3121(b) and 3306(c), “employment” is defined as any service, of whatever nature, performed by an employee for the person employing him.

Consistent with this definition, § 31.3121(a)-1(c) of the Employment Tax Regulations provides that the name by which the remuneration for employment is designated is immaterial. Section 31.3121(a)-1(d) further provides that generally, the basis upon which remuneration is paid to an employee is immaterial in determining whether the remuneration constitutes wages under FICA.

No specific section of the Code or regulations excepts from wages amounts paid to employees for providing equipment used in the performance of services as an employee. However, amounts paid to employees for certain employee business expenses incurred in connection with such equipment are excluded from wages if paid under a reimbursement or other expense allowance arrangement that meets the requirements of § 62(c).

Under § 1.62-2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the

requirements set forth in paragraphs (d), (e), and (f) of § 1.62-2 (business connection, substantiation, and return of excess). If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. § 1.62-2(c)(2)(i). Amounts 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. §§ 31.3121(a)-3, 31.3306(b)-2, 31.3401(a)-4, and 1.6041-3(h)(1).

If an arrangement does not satisfy one or more of these 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. §§ 1.62-2(c)(5), 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2), 31.3401(a)-4(b)(2), and § 1.6041-3(h)(1). Additionally, § 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 § 62(c) and the regulations thereunder, all payments made under the arrangement will be treated as made under a nonaccountable plan.

Rev. Rul. 68-624, 1968-2 C.B. 424, considered what portion of the total amount paid by a corporation for the use of a truck and the services of a driver was allocable as wages of the driver for federal employment tax purposes. The driver hauled stone from the corporation’s quarry to its river loading dock at a fixed amount per load. The corporation allocated one-third of the amount paid to the employee as wages and two-thirds as payment for the use of the truck. The ruling held that an allocation of the amounts 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 did not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation could have been 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.

Rev. Rul. 68-624 pre-dates the Tax Reform Act of 1986 (TRA '86), Pub. L. 99-514, and the Family Support Act of 1988, Pub. L. 100-485, which limit the deductions of employee business expenses. Pursuant to section 132 of TRA '86, which added § 67 to the Code, employee business expenses are allowed only as miscellaneous itemized deductions, to the extent that the aggregate of those deductions exceeds 2 percent of adjusted gross income. Section 62(c), which was enacted in the Family Support Act of 1988, in part limits employee business expense reimbursements that can be excluded from adjusted gross income to those paid under an accountable plan. Further, Rev. Rul. 68-624 does not address whether the truck driver was engaged in the trade or business of truck rental in addition to the trade or business of being an employee.

An arrangement that merely allocates compensation paid to an employee between wages and a reimbursement for business expenses will not meet the requirements of § 62(c). For example, in Shotgun Delivery, Inc. v. United States, 269 F.3d 969 (9th Cir. 2001), the court held that a courier company's arrangement that paid employee drivers 40 percent of the delivery charge rate less an hourly minimum wage payment did not meet the business connection requirement because the drivers were reimbursed regardless of actual mileage driven or expenses incurred. Accordingly, the arrangement was not a valid accountable plan under § 62(c).

CONCLUSION

Under the facts specified in Situations 1 and 2, the amounts paid to employees B, C, and D for providing equipment, including vehicles, used in performing services for the employer as an employee are not paid under an accountable plan. Each arrangement fails the business connection requirement because in each situation the employer pays an amount to the employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses that would be deductible under §§ 161 through 198. Each arrangement fails to require the employee to substantiate employee business expenses, as required by § 1.62-2(e). Finally, the arrangements do not require the return of excess as required under § 1.62-2(f).

HOLDING

In Situations 1 and 2, because the amounts paid to the employee for providing equipment, including vehicles, for use in performing services as an employee are not paid under an accountable plan, they are wages subject to the withholding and payment of income and employment taxes.

This ruling is not intended to provide guidance regarding the treatment of payment for equipment, including vehicles, provided by independent contractors.

See Rev. Proc. 2002-41, published elsewhere in this Internal Revenue Bulletin, regarding a deemed substantiation rule for use in implementing an accountable plan in

connection with reimbursements to certain employees for costs associated with providing welding rigs or mechanics rigs.

EFFECT ON OTHER REVENUE RULINGS

This ruling revokes Rev. Rul. 68-624.

EFFECTIVE DATE

This revenue ruling is effective for payments to employees after October 13, 1988 (the date of enactment for § 62(c), as part of the Family Support Act of 1988).

Under the authority of § 7805(b), a taxpayer that actually paid amounts separate from wages for the use of employee-provided equipment (such as described in Situation 1 and the truck described in Rev. Rul. 68-624) and reported these payments on timely issued Forms 1099 for calendar years beginning before January 1, 2002, may continue to report these payments on Form 1099 for periods ending on or before December 31, 2002.

DRAFTING INFORMATION

The principal author of this revenue ruling is Joe Spires of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in its

development. For further information regarding this revenue ruling, call Mr. Spires on (202) 622-6040 (not a toll free number).