DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Will E. McLeod
Assistant Chief, Employment Tax Branch 1
CC:TEGE:EOEG:ET1

SUBJECT: Self-Employment Tax on Proceeds from Video Poker

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ISSUE

Whether proceeds received by an occupant of a business establishment in exchange for providing space for video poker machines on the occupant's premises are includible in computing net earnings from self-employment?

CONCLUSION

The proceeds received by an occupant of a business establishment in exchange for providing space for video poker machines on the occupant's premises are includible in computing net earnings from self-employment.

FACTS

An owner of video poker machines enters into an arrangement to lease space from the owner of a business establishment. In exchange for the lease of space, the owner of the machines splits the proceeds from the machines with the business establishment on a percentage basis.

LAW AND ANALYSIS

Section 1401 of the I.R.C. imposes a self-employment tax on an individual's self-employment income. Section 1402(b) provides that the term "self-employment income" means the net earnings from self-employment derived by an individual, subject to certain limitations not relevant here. Section 1402(a) provides, in part, that the term "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 which are attributable to such trade or business, with certain exceptions.

Section 1402(a)(1) provides that there shall be excluded from net earnings from self-employment the rentals from real estate and from personal property leased with real estate together with deductions attributable thereto, unless such rentals are received in the course of a trade or business with exceptions not applicable here.

Treas. Reg. § 1.1402(a)-4(c)(1) provides that rentals from living quarters, where no services are rendered for the occupants, are generally considered rentals from real estate, except in the case of real estate dealers. However, Treas. Reg. § 1.1402(a)-4(c)(2) provides that where services are rendered for the occupants, payments for the use or occupancy of rooms or other space such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate. Consequently, such payments are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if the services are primarily for the occupant's convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

In Rev. Rul. 57-7, 1957-1 C.B. 435, an arrangement where a corporation placed coin-operated machines in various locations with the permission of the occupant of the premises in exchange for a stipulated percentage of the receipts from the machines, after deduction of certain expenses, was held to constitute a lease of

space. Furthermore, the percentage of the receipts paid to the occupant as lessor constituted rental payments, for which the machine owner is required to issue a Form 1099. Under the agreement, the occupant made change for customers and paid out any prizes or winnings. The corporation paid the costs of installing and repairing the machines, and any other expenses with respect to the machines. The corporation reimbursed the occupant for any payouts and then paid the occupant the agreed percentage of the balance.

Rev. Rul. 64-64, 1964-1 C.B. 320, was issued to amplify Rev. Rul. 57-7 to make it clear that a rental of space under the circumstances set forth in Rev. Rul. 57-7 is not considered to result in the payment of "rental from real estate" for purposes of Self-Employment Tax Act (SECA). Rev. Rul. 57-7 relates only to the filing of information returns, Forms 1096 and 1099.[1] Relying on Treas. Reg. § 1.1402(a)-1(c)(1)(iii) (now Treas. Reg. § 1.1402(a)-4(c)(2), Rev. Rul. 64-64 held that the remuneration received by the occupant of the premises does not constitute "rental from real estate" within the meaning of SECA and is includible in computing the "net earnings from self-employment" of the occupant.

This is currently the Service's position with respect to SECA tax liability on proceeds from the leasing of space for coin-operated machines. We note, however, that the regulation cited in Rev. Rul. 64-64 deals with rentals from living quarters which does not appear applicable to the leasing of space for coin-operated machines. We believe the Service should reconsider the rationale of Rev. Rul. 64-64 regarding how such transactions should be characterized with respect to SECA tax liability on the proceeds of coin-operated machines.

If you have any questions, please contact me or at (202) 622-6040.

WILL E. MCLEOD

[1]In Manchester Music Company, Inc. v. United States, 733 F. Supp. 473 (D.N.H. 1990), the court considered facts similar to Rev. Rul 57-7 and it rejected the reasoning of Rev. Rul. 57-7. See also Williamson Music Company, Inc. v. United States, 90-2 U.S.T.C. (CCH) ¶50,370 (D. Minn. 1990), where the court followed Manchester Music. In response to Manchester Music, Rev. Rul. 92-49, 1992-1 C.B. 433, states that the Service "will continue to take the position that an arrangement like that in Rev. Rul 57-7 is a lease of space upon which the amusements are placed." Finally, in In Re: Acme Music Company v. Internal Revenue Service, 196 B.R. 925, the Backruptcy Court found its facts to be similar to those in Manchester Music and Williamson. The court rejected both Rev. Rul. 57-7 and the Rev. Rul. 92-49 premise that classification of the arrangement as a lease versus a joint venture was determinative of whether a "payment" was made for purposes of Form 1099 reporting requirements.