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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) by Jerry E. Holmes
CC:EBEO:2

SUBJECT:

This Advice responds to your request for field service advice dated October 28, 1999.

LEGEND

taxpayer =

association =

members of association =

union =

workers =

x =

ISSUES

(1) Whether the non-interest portions of payments to former employees in settlement of a grievance relating to the violation of a collective bargaining agreement by an association of employers are wages subject to the taxes imposed

under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA).

(2) If the non-interest portions of the settlement payments are wages subject to FICA taxes and FUTA taxes, whether liability for these taxes is based on treating the wages as subject to these taxes in the year paid or in the year to which the payments relate.

(3) If the non-interest portions of the settlement payments are wages subject to FICA taxes and FUTA taxes based on the year in which they are paid, what language should a service center use on the Letter 105C in disallowing the claims.

(4) If the non-interest portions of the settlement payments are wages subject to FICA and FUTA taxes in the year paid, what action should be taken with respect to recovery of an erroneous refund of FICA taxes paid to the taxpayer.

CONCLUSIONS

(1) The non-interest portions of the settlement payments are wages subject to FICA and FUTA taxes.

(2) The non-interest portions of the settlement payments are subject to FICA and FUTA taxes at the rates in effect in the year the back wages are paid, and the applicability of the maximum wage base exceptions contained in sections 3121(a)(1) and 3306(b)(1) to any settlement payment is determined by the year in which the back wages are paid.

(3) Claims may be denied with the following language: “The settlement payments are remuneration for employment and no applicable exception from the definition of wages applies. The Service’s position is that liability for FICA and FUTA taxes is based on the year in which the wages are paid and not the year in which the services were performed. Rev. Rul. 89-35, 1989-1 C.B. 280. Therefore, your claim is denied.”

(4) One of the following approaches can be taken (subject to the applicable period of limitations) to recover an erroneous refund of FICA taxes: (a) the assessment of the tax; or (b) the institution of a suit by the Government to reduce the liability to judgment or an erroneous refund suit under section 7430.

FACTS

The taxpayer is a member of an association of employers that negotiated a collective bargaining agreement with the union for the workers in its industry. The collective bargaining agreement governed the performance of services by the workers in the industry. The collective bargaining agreement had numerous provisions related to salary and benefits to be paid workers. The exact amount of salary paid to a particular worker was provided for in individual contracts between each worker and the worker's employer that were entered into pursuant to the collective bargaining agreement. Disputes and grievances under the collective bargaining agreement were subject to mandatory arbitration.

The union filed a grievance, claiming that the members of the association had violated a provision of the collective bargaining agreement and had thereby reduced the salaries and benefits of certain workers. The arbitration panel found that the members of the association violated this provision of the collective bargaining agreement. An arbitrator found that the workers' pay and benefits had been reduced by the action of the members of the association, and determined the amount of the reduction in pay and benefits that the employees had collectively suffered for each of x different years. Before the arbitrator considered the amount of damages for other years, the union and the association reached a settlement agreement that provided for a lump sum to be paid into a fund, to be distributed to the workers based on the strength of the worker's claim that the worker suffered a loss in salary or benefits. The distribution to each worker specifically provided the year to which it related. Part of the distribution was described as interest. Under the settlement agreement, the members of the association were jointly and severally liable for the payments made under the settlement agreement to each of the workers.

The workers who received the settlement payments at issue performed services for the taxpayer as employees during the years to which the settlement payments relate. Under the settlement agreement, the taxpayer was jointly and severally liable for the payments made to its former employees under the distribution plan of the settlement agreement. The taxpayer withheld and paid FICA taxes and paid FUTA taxes with respect to the non-interest portion of the settlement.

The taxpayer has claimed refunds of FICA taxes and FUTA taxes paid with respect to the settlement payments. The FICA taxes related to a claim for refund for one quarter were refunded to the taxpayer. Other claims for refund of FICA and FUTA taxes with respect to the taxpayer's settlement payments are pending. The taxpayer has argued that the payments are not remuneration for employment, and thus do not fall within the basic definition of wages under the FICA and the FUTA. The taxpayer also has argued that, if the payments are back wages, they are

subject to FICA and FUTA taxation based on the year to which the settlement payments are attributable, and not the year paid.

LAW AND ANALYSIS

Issue (1) Whether the non-interest amounts paid under the settlement agreement constitute wages subject to FICA and FUTA taxes.

FICA and FUTA taxes are imposed on "wages" as that term is defined in I.R.C. § 3121(a) for FICA purposes and in § 3306(b) for FUTA purposes. I.R.C. §§ 3121(a) and 3306(b) define the term "wages," with certain exceptions not material here, as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." The term "employment" is defined in I.R.C. §§ 3121(b) and 3306(c) as "any service, of whatever nature, performed ... by an employee for the person employing him ...."

Section 31.3121(a)-1(i) of the Employment Tax Regulations, pertaining to FICA, provides that remuneration for employment, unless specifically excepted, constitutes "wages" even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them. See also section 31.3306(b)-1(i), relating to the FUTA.

The definitions of “wages” and “employment ” used in the FICA originated in the Social Security Act of 1935, Pub. L. No. 74-271, Section 210, and have been retained essentially unchanged. In Social Security Board v. Nierotko, 327 U.S. 358 (1946), the Supreme Court held that back pay awarded under the National Labor Relations Act to an employee who had been wrongfully discharged constituted "wages" for purposes of the Social Security Act. The Court noted that the back pay constituted remuneration and also held that the remuneration was for “employment” even though the back pay related to a period during which the petitioner did not perform any service. The Court emphasized the breadth of the definition of “employment” (Nierotko at 365-366, footnotes omitted):

> The petitioner urges that Nierotko did not perform any service. It points out that Congress in considering the Social Security Act thought of benefits as related to “wages earned” for “work done.”... We are unable, however, to follow the Social Security Board in such a limited circumscription of the word “service.” The very words “any service ... performed ... for his employer,” with the purposes of the Social Security Act in mind, import breadth of coverage. They admonish against holding that “service” can be only productive activity. We think that “service” as used by Congress in this

> definitive phrase means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer.

Nierotko has been cited in a number of recent cases dealing with the question of whether payments upon termination of employment or upon settlement of lawsuits for various employee rights are wages for federal employment tax purposes. Courts of Appeals have held that the definition of wages should be construed very broadly, and that back and front pay awards come within the broad definition of wages for federal employment tax purposes. Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997).

In Gerbec v. United States, 164 F.3d 1015 (6th Cir. 1999), the court considered whether payments in settlement of a suit under the Employee Retirement Income Security Act (ERISA) against the Continental Can Co. were includible in income and wages for FICA tax purposes. In discussing the FICA tax issue and citing Nierotko, the court held that "the phrase 'remuneration for employment' includes certain compensation in the employer-employee relationship for which no actual services were performed." 164 F.3d 1026. The court in Gerbec further stated as follows:

> ...The holding in Nierotko clearly supports the conclusion that awards representing a loss in wages, both back wages and future wages, that otherwise would have been paid, reflect compensation paid to the employee because of the employer-employee relationship, regardless of whether the employee actually worked during the period in question.

In Hemelt, the Fourth Circuit also emphasized the "expansive" language of the definition of wages and employment. That case involved the same settlement at issue in Gerbec. The court concluded that the "ERISA claims at issue ... related directly to taxpayers' employment relationship with Continental" and thus constituted wages for FICA tax purposes. See also Mayberry v. United States, 151 F.3d at 860.

In Associated Electric Coop., Inc. v. United States, 42 Fed.Cl. 867 (1999), the court held that certain termination payments paid to employees were wages for FICA tax purposes. The court stated as follows with respect to the definition of wages under the FICA (42 Fed.Cl. at 872):

> The notion of an "employer-employee relationship" continues to be recognized as the touchstone for determining if a particular payment is subject to FICA taxation. In addition, courts recently construing I.R.C.

> [section] 3121 have followed Nierotko by affording the terms "wages" and "employment" broad, inclusive coverage.

Under the broad definition of wages set forth in the above authority, the settlement payments made to the workers who were employees of the taxpayer are directly related to their employment relationships with the taxpayer and therefore are wages for federal employment tax purposes.

The taxpayer has argued that the settlement payments received by the workers do not constitute wages under the "origin and nature of the claim" doctrine. The taxpayer also argues that the origin of and nature of the workers' claim involved industry-wide violations of the collective bargaining agreement, and not wage claims based on individual contracts between a particular worker and employer. In addition, the taxpayer argues that the payments are not wages because the arbitration panel calculated the loss of salary on an industry-wide basis for each of the x years, and not on an individual worker basis. The taxpayer further argues that there is an insufficient nexus between the payment and the past performance of services for the payment to constitute wages for employment tax purposes.

We do not believe that the taxpayer's arguments are supported by the citations in its refund claim. The taxpayer has cited Rev. Rul. 55-320, 1955-2 C.B. 393; Rev. Rul. 58-301, 1958-1 C.B. 23; and Rev. Rul. 75-44, 1975-1 C.B. 15. These rulings do not apply to payments for the maintenance of a contract or contractual right and for the performance of services under a contract. The payments at issue in these rulings relate to the cancellation of a contractual right or contract. Rev. Rul. 55-520, 1955-2 C.B. 393, and Rev. Rul. 58-301, 1958-1 C.B. 23, hold that a lump sum payment received by an employee as consideration for the cancellation of his employment contract is gross income to the recipient in the year of receipt, but is not subject to FICA taxes or federal income tax withholding. Rev. Rul. 75-44, 1975-1 C.B. 15, holds that a lump sum payment received by a railroad employee in recognition of his agreement to relinquish certain rights with respect to his employment acquired through prior service as an employee is compensation for service under the Railroad Retirement Tax Act and wages for federal income tax withholding purposes.

Rev. Rul. 55-520 and Rev. Rul. 58-301 have no application to the instant distributions because these rulings concerned payments for the cancellation of a contract of employment and for the nonperformance of services by an employee under contracts of service for a term of years. In contrast to those rulings, the taxpayer's payments to the employees were not for the cancellation of the collective bargaining agreement but were to provide for the continuing validity of the disputed provision of the collective bargaining agreement. The payment basically

compensated the former employees of the taxpayer for the salary reduction or loss of benefits that they incurred with respect to their actual performance of services for the taxpayer. The payments were not for the non-performance of service but were for the performance of service at a salary and benefit level that was lower than what would have existed if the taxpayer and the other employers had not violated the provision of the collective bargaining agreement.

We also note that the workers derived no benefit from the settlement unless they had either performed sufficient service for employers in the association to be eligible for the benefits of the provision in the collective bargaining agreement. In this respect the rights were not unlike the rights acquired in Rev. Rul. 75-44, which were held to be wages. But unlike the payments in Rev. Rul. 75-44, the payments in this instance were not for the cancellation of the employee's rights under the collective bargaining agreement, which means that there is an even stronger case that these settlement payments are wages.

In the instant case, the taxpayer has also argued that because the taxpayer and the other members of the association were jointly and severally liable for the payment of the amounts under the settlement agreement and because the liability derived from the collective bargaining agreement, the taxpayer cannot be liable for the FICA and FUTA taxes. However, the terms of the collective bargaining agreement governed the aspects of the performance of services by the employees for the taxpayer, and contained numerous provisions governing the salary and benefits to be received by the workers. The settlement for the taxpayer's violation of the provision of the collective bargaining agreement was basically designed to provide each affected employee with the salary and benefits the employee would have otherwise received from the taxpayer during the years in question. This was exactly what the arbitration panel decided in arriving at the collective amount of the loss of salary and benefits for x years. These settlement payments for the shortfall in wages between the amount the former employees actually earned and the amount they would otherwise have earned from the taxpayer if there had been no violation are directly related to their employment relationships with the taxpayer and therefore are remuneration for employment for FICA and FUTA tax purposes.

In summary, the settlement payments received by the workers are essentially based on a determination of the amount the workers would have received but for the employers' violation of the collective bargaining agreement. The workers actually performed services for the taxpayer under the collective bargaining agreement and the dispute revolves around the employers' violation of a particular section of that agreement. The settlement payments basically were for services that were actually performed, but for which the workers were inadequately compensated or for benefits which the workers were denied. The payments are directly related to the

employment relationship with the taxpayer and thus are remuneration for employment and "wages."

The definition of wages under the FICA and FUTA is broad enough to include payments of remuneration for employment, regardless of the origin of the funds for the payment of the remuneration. See Lane Processing Trust v. United States, 25 F.3d 662 (8th Cir.) (distributions from trust to employees from proceeds of sale of company are wages for FICA and FUTA purposes); and STA of Baltimore - ILA Container Royalty Fund v. United States, 621 F.Supp. 1567, 1570 (D.Md. 1985), aff'd, 804 F.2d 296 (4th Cir. 1986) (payments of benefits from fund designed to compensate for loss of jobs due to containerization which payments were conditioned on the performance of a specified number of hours of work by the employee were wages for FICA and FUTA purposes).

Issue (2) Whether the liability for FICA and FUTA taxes is based on the year the wages are actually paid or the year (or years) to which the wages are attributable.

The law, regulations, and legislative history support the position that FICA taxes and FUTA taxes are applied to back pay based on the year of receipt and not on the years to which they are attributable.

A. Law, Regulations, and Legislative History relating to rate of FICA and FUTA tax.

I.R.C. § 3101 imposes FICA tax on the wages of employees, and section 3102 provides that such taxes shall be collected by the employer by deducting the amount of the tax from the wages as and when paid. I.R.C. §§ 3101(a) and (b) provide that the rate of tax depends on the calendar year in which the wages are received by the employee. Treas. Reg. § 31.3101-2(c) provides that the employee tax is computed by applying to the wages received by the employee the rate in effect at the time such wages are received. See the example set forth therein. Treas. Reg. § 31.3101-3 provides that "The employee tax attaches at the time that the wages are received by the employee." The regulations further state that "In general, wages are received by an employee at the time that they are paid by the employer to the employee." Treas. Reg. § 31.3121(a)-2. No exception is made in the regulations for the receipt of back pay awards.

I.R.C. § 3111 imposes employer FICA taxes on the wages paid with respect to employment. Section 3111(a) and (b) provide that the rate of tax depends on the calendar year in which the wages are paid by the employer.

I.R.C. § 3301, relating to the FUTA, imposes on every employer a tax equal to 6.2 percent of the total wages (as defined in § 3306(b)) paid by the employer during the calendar year with respect to employment (as defined in § 3306(c)).

The legislative history of the FICA provisions supports the position that the rate of tax depends upon when the wages are actually or constructively received, not when the services were performed. The history of the provisions imposing FICA tax rates (current sections 3101 and 3111) demonstrates a specific Congressional rejection of the concept of imposing rates based on when services were performed. As originally enacted, the rate of FICA tax was computed by applying the rate in effect at the time of the performance of the services for which the wages were paid or received. See sections 801 and 804 of the Social Security Act of 1935, Pub. L. No. 74-271, 49 Stat. 620.

The Social Security Act Amendments of 1939, Pub. L. No. 76-379, 53 Stat. 1360, provided for increases in the rate of FICA tax, and also provided that the rate of tax would be based on when the wages were received, rather than the old rule of when the services were performed. See sections 601 and 604 of the 1939 Amendments. The legislative history in connection with the Social Security Act Amendments of 1939 indicates a concern for the problems that could arise in years in which the rates changed, if the rate of tax continued to be determined by when the services were performed rather than when the wages were received:

> ... Sections 1400 and 1410 of the Internal Revenue Code [the predecessors of sections 3101 and 3111, respectively] now provide that the rate of tax applicable to wages is the rate in effect at the time of the performance of the services for which the wages are paid. This will unnecessarily complicate the making of returns and the collection of the taxes in later years when the rate of tax has been increased. For example, in 1943 the rate of tax increases from 1 percent to 2 percent. Thus, wages which are paid in 1943 for services performed in 1942 will be subject to the 1-percent rate, while wages paid in 1943 for services performed in that year will be subject to the 2-percent rate. Provision must therefore be made in the return for 1943 for the reporting of wages subject to the different rates, and in auditing the returns, it will be necessary to ascertain not merely the time when the wages were paid and received, but also the year of the rendition of the services for which the wages are paid. If employers have failed to make the proper distinctions, many refunds and additional assessment will doubtless be necessary and confusion will result. Under the amendment the rate applicable would be the rate in effect at the time that the wages are paid and received without reference to the rate which was in effect at the time the services were performed.

[Emphasis added.] H.R. Rep. No. 76-728, 76th Cong., 1st Sess. 1, 57-58 (1939). See also Sen. Rep. No. 76-734, 76th Cong., 1st Sess. 1, 70-71 (1939), which contains the identical language.

In addition, the relevant legislative history of the FUTA tax parallels the legislative history of the FICA. As originally enacted by section 901 of the Social Security Amendments of 1935, the unemployment tax was imposed on the "total wages ... payable ... (regardless of the time of payment) with respect to employment during such calendar year" and the rates imposed were based on the year of employment. Section 608 of the Social Security Act Amendments of 1939 amended section 1600 of the 1939 Code (the predecessor of section 3301) to impose the tax on a percentage of the "total wages ... paid ... during the calendar year with respect to employment...." This FUTA amendment was made at the same time as the amendment to the FICA imposing taxes on a when paid basis. The Congressional intention to have the FICA and FUTA tax imposed on the same wages paid basis is evident from the legislative history:

> This amendment changes the basis for determining tax liability under ... [the FUTA] from "wages payable" to "wages paid." ...[The FUTA] is thus brought into conformity with ... [the FICA], which also imposes a tax on "wages paid." Wages, for the purposes of these taxes, are considered paid when they are actually paid, or when they are constructively paid, i.e., credited to the account of, or set apart for the wage earner so that they may be drawn upon him at any time although not then actually reduced to possession.
> ...
> With both the old-age insurance tax and the unemployment-compensation tax on the wages paid basis, the keeping of records by employers will be simplified.

H.R. Rep. No. 76-728, 76th Cong., 1st Sess. 1, 62-63 (1939). See also Sen. Rep. No. 76-734, 76th Cong., 1st Sess, 1, 75-76. This change in the FUTA provisions is reflected in Treasury Regulations 107 (Part 403, Title 26, C.F.R. (1940 Sup.), section 403.227.

Since the date of this change, changes in rates have been based on when the wages were received or paid (not when the services were performed), as reflected in the current Code sections 3101, 3111, and 3301. The taxpayer's position creates the kind of problems that Congress sought to avoid by amending the Code in 1939 to provide for the determination of wage rates based on when the wages are paid and received.[1]

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[1] Section 3121(v)(2) contains a special rule providing that amounts deferred under a nonqualified deferred compensation plan are taken into account for FICA tax purposes the later of when the services were performed or when there is no substantial risk of forfeiture of the amount deferred. Section 3306(r)(2) contains a similar rule for

B. Law, Regulations, and Legislative History Relating to Maximum wage base provisions.

For FICA purposes, section 3121(a)(1) contains the exception from the definition of wages for payments in excess of the social security contribution and benefit base. Section 3121(a)(1) provides that the term wages shall not include "in the case of taxes imposed by sections 3101(a) and 3111(a) that part of the remuneration which, after remuneration ... equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) with respect to employment has been paid to an individual by an employer during the calendar year with respect to which such contribution and benefit base is effective, is paid to such individual by such employer during such calendar year." Although this provision reflects that it has been amended to eliminate the maximum for purposes of the Medicare tax, the basic language taking into account amounts only if they are "paid to such individual by such employer during such calendar year" has remained unchanged since 1946 (see below). This language requires payment during the same calendar year by the employer for the employer to avail itself of the section 3121(a)(1) exception with respect to wage payments.

For FUTA purposes, section 3306(b)(1) provides the exception from wages for remuneration paid by an employer to an employee during a calendar year after $7,000 of wages has been paid to the individual by such employer during such calendar year. See section 31.3306(b)(1)-1(a) of the regulations. Thus, the FUTA maximum wage base is also based on the wages paid during the calendar year.

The legislative history of this provision also supports our position that the availability of the exclusion from FICA wages under section 3121(a)(1) and the exclusion from FUTA wages under section 3306(b)(1) for payments made above the respective maximum wage bases is based solely on the wages paid during the calendar year and does not depend on the year in which the services to which the wages relate were performed.

The taxpayer relies on section 3121(a)(1) and section 3306(b)(1), the maximum wage base exclusions, to argue that this back pay is excluded from the wages of its employees, because it believes the wages should be allocated to the years in which the services were performed for purposes of determining the applicability of section 3121(a)(1) and section 3306(b)(1). However, the legislative history of these

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FUTA purposes. Neither section 3121(v) nor section 3306(r) applies in this case, but they demonstrate that a departure from the taxation of wages when paid rule must be based on a legislative change.

provisions evidences a rejection of the concept of allocating wages based on when the services were performed for purposes of the maximum wage exclusions.

Under the law as it existed at the time the Supreme Court rendered the Nierotko decision, the predecessor of section 3121(a)(1) provided that availability of the FICA maximum wage exclusion did depend on the year that the services were performed. Section 1426(a)(1) of the Internal Revenue Code of 1939, as codified prior to the 1946 amendment, provided an exception for "that part of the remuneration which, after remuneration equal to $3,000 has been paid to an individual by an employer with respect to employment during any calendar year, is paid to such individual by such employer with respect to employment during such calendar year." (Emphasis added.) The wages received in a particular year were "allocated" to the year in which the services were performed for purposes of determining the applicability of the maximum wage exclusion regardless of the year of payment.

The maximum wage base exception provided by the predecessor of section 3121(a)(1) was amended by section 412(a) of the Social Security Amendments of 1946, Pub. L. No. 79-719, 60 Stat. 978 (the 1946 Amendments). This law was enacted on August 10, 1946, after the Nierotko decision had been issued.[2] The Committee Reports in connection with these changes provided as follows:

> This section amends the $3,000 limitation contained in the definition of the term "wages" in section 1426(a)(1) and section 1607(b)(1) of the Internal Revenue Code for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, respectively. Under the definition of the term contained in existing law there is excluded from "wages", for such purposes, all remuneration with respect to employment during any calendar year paid to an individual by an employer (irrespective of the year of payment) after remuneration equal to $3,000 has been paid to such individual by such employer with respect to employment during such year. This section amends such definitions, effective January 1, 1947, to constitute as the yardstick the amount paid during the calendar year (with respect to employment to which the taxes under the code are applicable), without regard to the year in which the employment occurred.
>
> ...[T]he new exclusion applicable to remuneration payments made after December 31, 1946, ...excludes from "wages" that part of remuneration which, after remuneration equal to $3,000 with respect to employment after 1936 has been paid to an individual by an employer during any calendar year

[2] The Nierotko decision was issued on February 25, 1946.

> after 1946, is paid to such individual by such employer during such calendar year. Thus in applying the $3,000 limitation on wages, the employer, employee, and those administering the taxes may, beginning with the calendar year 1947, look only to the amount of remuneration paid by the employer to the employee during the calendar year, and exclude all remuneration paid during the calendar year after $3,000 has been paid during the year with respect to employment performed on or after January 1, 1937 (that is, the employment with respect to which the taxes by sections 1400 and 1410 of the Federal Insurance Contributions Act are applicable).

[Emphasis added.]
H. R. Rep. No. 79-2447, 79th Cong., 2d Sess. 1, 35 (1946).

The regulations were soon amended to reflect this change in the law. See T.D. 5566, 1947-2 C.B. 148. Since the date of this amendment, the FICA maximum wage limitation has been based on the remuneration paid during the calendar year without regard to the year the services relating to that remuneration were performed. See section 3121(a)(1) and section 31.3121(a)(1)-(a)(2) of the regulations.

Applying the exclusion provided by section 3121(a)(1) based on the year to which the payments are attributable rather than the year that they are paid is inconsistent with the 1946 amendment and with the above legislative history. Under the taxpayer's "allocation principle," an employer making a back pay payment in one year that related to five previous years would be liable for FICA taxes based on treating the payments as being made in all five years. The employer could be liable for FICA taxes up to the base for each of the five years even though the payment was made in one year. This allocation contravenes both the language of section 3121(a)(1) and the legislative history.

The history of the FUTA maximum wage base exception is similar to that of the FICA. The predecessor of the FUTA maximum wage base exclusion under section 3306(b)(1) formerly provided that the exclusion was based on remuneration paid with respect to employment during the calendar year (regardless of when paid). See section 1607(b)(1) of the 1939 Code, prior to the 1946 Amendments. When the FICA maximum wage exclusion was amended to its present standard of remuneration paid during the calendar year (regardless of when the employment occurred), a "corresponding change" was made in the FUTA maximum wage base exclusion. See section 412(b) of the 1946 Amendments, and the quotation supra from H.R. Rep. No. 79-2447. This amendment provided that the FUTA maximum wage base provision excluded from wages all remuneration paid by the employer to the employee during the calendar year after $3,000 had been paid during the year

with respect to employment under the FUTA. The implementing regulation concerning this change are found in T.D. 5566, 1947-2 C.B. 148, amending section 403.228(a). Thus, the FICA and FUTA maximum wage base exclusion were amended to the use the same standard: remuneration paid during the calendar year for employment without regard to the year of employment.

C. Case Law Discussion

As described above, the statutory and regulatory framework for both FICA and FUTA taxes, by calculating such taxes using rates and amounts for the year wages are paid and received, supports the position that employment taxes arise in the year of payment and receipt of wages, rather than in the year the wages are earned. Although the law, regulations, and legislative history offer support for the Government, there is a split of authority among the circuits on the issue.

The Sixth Circuit supports the taxpayer's position on this issue. In Bowman v. United States, 824 F.2d 528 (6th Cir. 1987), the Sixth Circuit held that, for FICA tax purposes, a settlement award for back wages in a race discrimination lawsuit should be allocated to the years to which such back pay related, rather than to the year of the award. Bowman relied upon Social Security Bd. v. Nierotko, 327 U.S. 358 (1946), which dealt with eligibility for Social Security benefits. The Court in Nierotko concluded that, for Social Security benefit purposes, a back pay award under the National Labor Relations Act, should be allocated to the years for which the back pay was awarded, since the periods of time during which wages are earned are crucial for eligibility for Social Security benefits.

In Rev. Rul. 89-35, 1989-1 C.B. 280, the Service has indicated that it will not follow Bowman. The revenue ruling based its conclusion on the statutory language and the regulations discussed above, and prior revenue rulings. See Rev. Rul. 55-203, 1955-1 C.B. 114, which holds that liability for social security taxes is computed on an "as paid" basis when the taxpayer receives unpaid minimum wages or unpaid overtime compensation pursuant to the Fair Labor Standards Act; and Rev. Rul. 78-336, 1978-2 C.B. 255, which holds that a back pay award ordered by a court is wages in the year paid, not in the year or years earned, and is subject to federal income tax withholding at the rates in effect at the time the award is paid.

On January 25, 1999, a district court in the Sixth Circuit followed Bowman in considering the issue of when back pay is treated as subject to FICA and the FUTA taxation. Cleveland Indians Baseball Co. v. United States, 83 A.F.T.R. 2d (RIA) 717, 99-1 U.S. Tax Cas. (CCH) ¶ 50, 235 (N.D. Ohio 1999), appeal pending, No. 99-3410 (6th Cir.). The district court stated that it was constrained to rule in favor

of the taxpayer because Bowman provided the controlling precedent in the Sixth Circuit.

Bowman was cited in Johnston v. Harris County Flood Control Dist., 869 F.2d 1565, 1580 (5th Cir. 1989), cert. denied, 493 U.S. 1019 (1990), where the court stated that "[a]t least for purposes of FICA (Social Security) taxes, a plaintiff receiving a back pay award is liable for the taxes that would have been accrued in the year the wages were due...." However, that case involved liability for violation of the plaintiff's civil rights and the United States was not a party to the proceeding.

Other courts have supported the Service's position on this issue. In Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997), the Fourth Circuit held that payments received in settlement of a claim under the Employee Retirement Income Security Act (ERISA) were wages for FICA tax purposes. In that case the taxpayers argued that the payments that the taxpayers received should be taxed based on the years to which the payments were attributable rather than the year in which they were paid. However, the court rejected that claim (122 F.3d at 210-211):

> Taxpayers' final claim, that the payments they received should be allocated to the years to which they are attributable and taxed at the rate prevailing in each of those years, is also meritless. It is clear under the Treasury Regulations that "wages" are to be taxed for FICA purposes in the year in which they are received. See C.F.R. § 31.3121(a)-2(a) ("In general, wages are received by an employee at the time that they are paid by the employer to the employee.")...

Similarly, in Mazur v. Commissioner, 986 F. Supp. 752 (W.D. N.Y. 1997), the court declined to follow Bowman and held that back pay is wages for FICA tax purposes in the year paid and not the year earned. The court placed great weight on the fact that the regulation which deems the FICA tax to attach upon the actual or constructive receipt by an employee was promulgated more than sixty years ago. See article 203 of Treasury Regulations 91, 1 Fed. Reg. 2050, 2065 (November 11, 1936). The "regulation has not been substantially altered or amended since its promulgation." Citing Cottage Savings Assn. v. United States, 499 U.S. 554, 561 (1991), and Helvering v. Winmill, 305 U.S. 79, 83 (1938), the court invoked the principle that "Treasury regulations which have prevailed without change are deemed to have received Congressional approval and to have the authoritative weight of statutory law." The court noted that "[s]uch weight was not afforded in Bowman." 986 F. Supp. at 755.

The Mazur court also rejected the rationale of applying language in Nierotko relating to the allocation of earnings for social security benefit purposes to the

determination of the rate and timing of FICA taxation. The court noted that Nierotko was a case about eligibility for social security benefits and that the Supreme Court had relied upon the purpose of the Social Security Act to reach the conclusion that Congress intended to treat back pay as wages. The court noted that "the conclusion that back pay should be allocated to the years in which such was earned was reached solely with respect to the accrual of benefits and was apparently not based on any precedent except the prevailing practice of allocating back pay awards for the purpose of federal income tax, which practice no longer endures." 986 F.Supp. at 756. The court pointed out that the Supreme Court specifically recognized that its allocation for social security benefit purposes may have had the effect of qualifying the employee for social security benefits. Id. at 756. Therefore, the Mazur court declined to follow Bowman in its application of the allocation principle in Nierotko to FICA taxation, noting that the regulation had been promulgated more than sixty years previously, and had not been substantially altered or amended since then, and that Treasury regulations which have prevailed without change are deemed to have received Congressional approval and to have the authoritative weight of statutory law.

In a case decided before Bowman, the Second Circuit followed the approach in the regulations that wages are subject to FICA tax as and when paid in the case In re Freedomland, Inc., 480 F.2d 184 (2d Cir. 1973), aff'd sub nom Otte v. United States, 419 U.S. 43 (1974). Freedomland indicates that payments by a bankruptcy trustee for wages earned by employees prior to the employer's bankruptcy were wages for FICA tax purposes in the year of payment rather than wages in the year earned. See the discussion of the increase in the FICA tax rate (480 F.2d at 189) and footnote 8 (480 F.2d at 189). The court in Freedomland stated that "[t]he taxes are by law calculable only when the wages claims are paid and not until then..." 480 F.2d at 190.

In summary, the Mazur opinion (written by a district court in the Second Circuit), Freedomland (a Second Circuit opinion), and Hemelt have held that back pay is subject to FICA tax when paid and not when earned. In addition, the statutory language and legislative history before and after the Nierotko case support the Service's position. Also, the long-standing administrative position of the Service in regulations and rulings has been that back pay is wages in the year paid.

Accordingly, it is our position that FICA and FUTA liability for the settlement payments is determined based on when the wages are paid. Therefore, the FICA and FUTA tax rates are determined based on the year in which the wages were actually paid. Also, the applicability of the maximum wage base exceptions (sections 3121(a)(1) and 3306(b)(1)) is determined based on when the settlement

payments were actually paid, and not when the services to which the settlement payments relate were performed.

Issue (3): What language should be used in denying refunds related to these settlement payments.

Two basic issues have been raised: (a) whether the non-interest portions of the payments are "remuneration for employment" and thus wages; and (b) if the payments are wages, whether they are treated as wages paid in the year of actual payment for purposes of determining whether the exceptions provided by section 3121(a)(1) and section 3306(b)(1) apply.

Accordingly, the following language may be used in denying a claim:

> The settlement payments are remuneration for employment and no applicable exception from the definition of wages applies. The Service's position is that liability for FICA and FUTA taxes is based on the year in which the wages are paid and not the year in which the services were performed. Rev. Rul. 89-35, 1989-1 C.B. 280. Therefore, your claim is denied.

As a general rule, if a FICA or FUTA refund claim (a) involves employer payments of back pay under a statute, (b) makes a reasonable argument raising the Bowman issue of timing of FICA and FUTA taxation, and (c) is in the Sixth Circuit (Kentucky, Michigan, Ohio, and Tennessee), the claim should be placed in suspense pending the resolution of Cleveland Indians Baseball Co. v. United States.

Issue (4): How should an erroneous refund of FICA taxes with respect to the non-interest portion of the settlement payments be recovered.

In order to recover the erroneous refund in question, a new determination of the taxpayer's liability, either administrative or judicial, must take place. Singleton v. United States, 128 F.3d 833 (4th Cir. 1997). If the administrative approach is chosen, a new or a supplemental assessment of the taxpayer's correct tax liability must be made within the applicable limitations period. I.R.C. § 6501.

Employment taxes are not subject to the restrictions placed on deficiencies. I.R.C. § 6212; Traxler v. United States, 88-2 U.S.T.C. ¶ 9627 (E.D. Cal. 1988). Accordingly, the Service need not issue a statutory notice of deficiency to the taxpayer, and may assess the tax due summarily. Once the new assessment is made, the Service will have 10 years from the date of assessment to collect the tax.

In the alternative, the Service may institute either a suit to reduce the liability to judgment (brought within the three-year assessment period) or an erroneous refund suit pursuant to I.R.C. § 7405. The erroneous refund suit must be brought within two years from the date the taxpayer received the erroneous refund check. O'Glivie v. United States, 519 U.S. 79 (1996).

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

With respect to issue (4) and the period of limitations on an assessment, in the present case, the taxpayer's Form 941 for the quarter ending June 30, [redacted], was deemed filed on April 15, [redacted]. I.R.C. § 6501 (b)(2). Thus, the Service has until April 15, [redacted] to assess the previously abated FICA taxes.

With respect to issue (4) and the period of limitations on an erroneous refund suit, in the instant case, the erroneous refund was received by the taxpayer on August 2, 1999. Therefore, the Service has until August 2, [redacted] to institute the erroneous refund suit against the taxpayer.

[redacted]

If you have any questions, please call the branch.