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

CHIEF COUNSEL

March 13, 2002

Number: **INFO 2002-0103**
Release Date" 6/28/2002

CC:TEGE:EOEG:ET2
GENIN-102993-02
UIL: 3121.02-07

[redacted]

Reference: "Continuing Employment Exception" - Internal Revenue Code § 3121(u)(2)(C)

Dear [redacted]

This letter responds to your written inquiry, dated October 31, 2001, requesting that we determine whether or not services performed by an employee of the [redacted] (University) are exempt from medicare tax pursuant to the "continuing employment exception" set forth in Internal Revenue Code (Code) § 3121(u)(2)(C).

As we understand the facts you have provided, the employee in question was employed by the University on December 28, 1979; laid off on June 30, 1994; and reemployed on March 5, 1995. Currently, the employee is still employed by the University. During the period between June 30, 1994, and March 5, 1995, the employee worked for several months with a private employer.

As a general matter, apart from the procedure for issuing a formal opinion, as described in Revenue Procedure 2002-1, 2002-1 I.R.B. 1, the Internal Revenue Service is not able to provide binding legal advice applicable to particular taxpayers. Your request does not conform to the requirements of Revenue Procedure 2002-1 and, therefore, does not provide the necessary information to issue a formal opinion applying Code § 3121(u)(2)(C) to your specific facts. However, we are pleased to provide you with the following general information regarding the "continuing employment exception" to medicare tax, which we hope will be helpful.

Taxes under the Federal Insurance Contributions Act (FICA) are computed as a percentage of "wages" paid by the employer and received by the employee with respect to "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment." There are two taxes that comprise FICA taxes: old-age, survivors, and disability insurance tax (OASDI) and hospital insurance tax. Old-age, survivors, and disability insurance tax, also known as social security tax, is imposed

under Code §§ 3101(a) and 3111(a). Hospital insurance tax, also known as medicare tax, is imposed by Code §§ 3101(b) and 3111(b).

Section 13205(a)(1) of the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 313 (codified in various sections of U.S.C.), amended Code § 3121(u). In general, the amendment applies Code §§ 3101(b) and 3111(b), the medicare portion of FICA, to wages for services rendered after March 31, 1986, by newly hired employees of states and political subdivisions. Previously, most employees of states and political subdivision were not covered under FICA, as their services were excepted from the term "employment" by Code § 3121(b)(7).

Code § 3121(u)(2) provides an exception to Code § 3121(b)(7) and subjects certain state and local government employees to medicare taxes. Under Code § 3121(u)(2), except in limited circumstances, services performed by state and local government employees hired after March 31, 1986, who are not subject to a "218 agreement"[1] are considered "employment" for medicare tax purposes. In contrast, such services in the absence of a 218 agreement continue to be exempt from the OASDI portion of FICA under Code § 3121(b)(7).

Under Code § 3121(u)(2)(C), services performed by state or local employees hired on or before March 31, 1986, continue to be exempt from medicare taxes (if Code § 3121(b)(7) otherwise applies), provided that such employees

1. were performing substantial and regular services for the state or political subdivision employer before April 1, 1986,

2. were bona fide employees of such employer on March 31, 1986,

3. had a relationship with such employer that was not based on the avoidance of medicare tax, and

4. had an employment relationship with such employer that was not terminated at any time since March 31, 1986.

This exception is referred to as the "continuing employment exception."

Revenue Ruling 86-88, 1986-2 C.B. 172 provides guidelines related to the application of Code § 3121(u) (medicare tax) to wages of newly hired employees of states and political subdivisions. The situation presented in Q/A 5 of this revenue ruling appears to be applicable to the facts of this matter. A state employee who performed regular and

---

[1] A "218 agreement" is an agreement between a state or political subdivision thereof and the Secretary of Health and Human Services pursuant to § 218 of the Social Security Act, 42 U.S.C. § 418 (2001) extending social security coverage to employees of such state or political subdivision.

substantial services for remuneration prior to April 1, 1986, and whose employment relationship with the state employer was terminated after March 31, 1986, was later rehired by the state employer. The revenue ruling determined that the continuing employment exception did not apply to the state employee based on Code § 3121(u)(2)(C), which is discussed in the above paragraph.

Revenue Ruling 86-88 in Q/A 6 defines "termination of employment" for purposes of Code § 3121(u)(2)(C) as a question of fact. This determination must be based on the relevant facts and circumstances of the particular situation. The revenue ruling also explains that "[g]reat weight, however, will be given to the personnel rules of the state employer or political subdivision employer to determine if an employment relationship has been terminated."

However, Revenue Ruling 88-36, 1988-20 I.R.B. 22, which supplements Revenue Ruling 86-88, provides another example in which an employee's employment was considered continuing even though the employee was notified that she would be terminated as of the end of May 1986 because the school district might not receive sufficient funding. The employee continued to be covered under the school district's health insurance program through August 1986 on the same basis as before May 1986. In September 1986, sufficient funding was provided and the employee began working with the same employer on the same basis as before May 1986. The revenue ruling determined that the employment was continuous (i.e., not terminated as provided in Code § 3121(u)(2)(C)) because the school district received sufficient funding and its personnel policies indicated that the employment relationship continued because the "terminated" employee retained health insurance coverage.

Both revenue rulings indicate that the determination of whether an employment relationship is terminated is based on the facts presented with particular emphasis on the personnel policies of the employer. Consequently, in applying this information to your situation, you would determine whether the employment relationship has been terminated in the same manner.

If you have any additional questions or need further assistance, please contact Patricia P. Holdsworth, , at (202) 622-6040.

Sincerely,
Lynne A. Camillo
Acting Branch Chief
Employment Tax Branch 2
Office of the Assistant Chief Counsel
(Exempt Organizations/Employment Tax/
Government Entities)