Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:EBEO:Br2
Date:
January 11, 1999

Legend

School District A =

School District B =

New School District =

State X =

Dear

This is in response to your request, dated November 6, 1998, for a letter ruling concerning the availability of the exemption from Medicare tax contained in section 3121(u)(2)(C) of the Internal Revenue Code (the Code) to certain school district employees after the unification of two school districts to form a new school district.

FACTS

School Districts A and B are an elementary school district and a high school district. The State X Board of Education adopted a resolution approving the unification of School District A and School District B. A referendum for the unification was voted on and approved by the electorate. On , following passage of the referendum, School District A and School District B ceased to exist and New School District began.

New School District continued to employ the employees of School Districts A and B. Among them were employees who were employed prior to April 1, 1986, and who have been continuously employed, performing regular and substantial services, since that date. Following the unification, the employees of New School District who were previously employed by School Districts A and B were treated as having been

continuously employed, and as having the same status after the unification as they had before the unification. As a result, after the unification such employees retained their pre-unification seniority, tenure, benefits, and other attributes of employment.

You represent that the employees of New School District continued to participate in the State X Teachers Retirement System after unification. In addition, you represent that the employees covered by this request are not subject to an agreement under section 218 of the Social Security Act.

You request that we rule that the employees of New School District who were hired by District A or B before April 1, 1986, and who before unification were eligible for the continuing employment exception under Code section 3121(u)(2)(C), will continue to be eligible for the exception following unification.

LAW AND ANALYSIS

Taxes under the Federal Insurance Contributions Act (FICA) consist of an old-age, survivors, and disability (OASDI) portion and a hospital insurance (Medicare) portion. FICA taxes are computed as a percentage of "wages" paid by the employer 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."

Section 3121(b)(7)(F) of the Code generally expands the definition of employment for FICA purposes to include service performed after July 1, 1991, by an employee of a state or local government entity unless the employee is a member of a qualified retirement system.

Section 3121(u) provides that with respect to state and local government employment, Medicare taxes shall be applied without regard to whether the employee is a member of a qualified retirement system. However, section 3121(u)(2)(C) provides an exception to Medicare coverage for services performed by state or local government employees hired before April 1, 1986, provided that such employees were performing regular and substantial services for pay before that date, were employed in good faith before that date, had been hired for purposes other than avoiding the Medicare taxes, and have not at any time on or after that date experienced a termination of the employment relationship with the employer. This is termed the "continuing employment exception."

Rev. Rul. 86-88, 1986-2 C.B. 172, states the Service’s position concerning the continuing employment exception and the applicability of the Medicare tax. Rev. Rul. 86-88 provides that the term "political subdivision" has the same meaning that it has

under section 218(b)(2) of the Social Security Act, 42 U.S.C. section 418(b)(2). Thus, the term "political subdivision" ordinarily includes a county, city, town, village, or school district. Under this definition, if an employee simply ceased to work for one school district and began to work for another, he or she would have transferred from one political subdivision employer to another political subdivision employer.

However, Board of Education of Muhlenberg County v. United States, 920 F.2d 370, 91-1 USTC 50,125 (6th Cir. 1990), holds that the Code does not explicitly address the application of the continuing employment exception in cases of merger or consolidation of entities. Under this case, a consolidated school district formed when three formerly independent school districts merged into one is not a new employer for purposes of the continuing employment exception. The court turned to the legislative history to determine that the purpose of Code section 3121(u)(2)(C) was to protect state and local government entities from a sudden increase in Medicare taxes. H.R. Rep. No. 99-241, 99th Cong. 1st Sess., Pt. 1, at 25-27. The court concluded that Congress did not intend to treat a merger or consolidation of two or more employers as creating a new employer for purposes of Code section 3121(u)(2)(C) because such treatment would create the same sudden financial burden on state and local governments that the exception was drafted to mitigate, and would deter consolidation of local government entities for purposes of enhancing efficiency. Accordingly, the court held that the taxpayer was not a new employer for its post-merger employees, who in substance worked continuously for the same employer under a different name.

We conclude that the unification of School Districts A and B, which was authorized by popular referendum, does not give rise to a new employer. This conclusion is consistent with Board of Education of Muhlenberg County. Therefore, for purposes of Code section 3121(u)(2)(C), New School District will not be treated as a new employer.

Accordingly, we rule that the employees of New School District who were hired by District A or B on or before March 31, 1986, and who before unification were eligible for the continuing employment exception, continue to be eligible for the continuing employment exception under section 3121(u)(2)(C) following the unification of the districts.

Except as specifically ruled on above, no opinion is expressed as to the federal

tax consequences of the transaction described above under any other Code provision. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

JERRY E. HOLMES
Chief, Branch 2
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)