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TY:

Legend

Union =

City =

State =

Retirement Plan =

x =

year c =

Dear :

This is in reply to your request for a ruling concerning (1) whether settlement distributions made under a settlement agreement by the Union to employees of the City are “wages” subject to social security tax, Medicare tax, income tax withholding, and Federal Unemployment Tax Act (FUTA) tax; and (2) how these settlement distributions are reported for federal tax purposes.

The Union is a nonprofit corporation under State law that has been recognized by the Internal Revenue Service (IRS) as an organization exempt under section 501(a) of the Internal Revenue Code (Code) as an organization described in section 501(c)(5). Its members are all employees of the City.

The City recognizes the Union as the sole bargaining agent for its member employees of the City. The City and the Union have entered into collective bargaining agreements (CBAs) which in part define the conditions of employment, including compensation.

The City and the Union entered into a CBA that provided for wage increases. Because of an alleged budget shortfall, the City did not implement the wage increases for one of the fiscal years (year c) covered by the CBA.

The Union sued the City for breach of the CBA. After the case had been litigated and was in an appellate stage, the Union and the City reached a settlement, under which the City agreed to make a lump sum payment to the Union of x dollars in full settlement of the Union's claims. Under the settlement agreement, the Union is responsible for distributing the payments (the "settlement distributions") to its member City employees. The settlement agreement provides that the Union is responsible for the determination of the employees that are eligible for a settlement distribution and for the determination of the exact amount of the settlement distribution to be paid to each employee. The settlement agreement provides that those member employees who were employed by the City during fiscal year c are entitled to a settlement distribution. Those employees will receive the same distribution amount regardless of position or tenure, provided, however, that those employees who were employed for only a portion of the fiscal year c will receive a pro rata share. The Union must issue each affected employee a separate check.

The settlement agreement also requires the Union to indemnify the City for any claims raised by the employees regarding the settlement agreement or the settlement distributions. The agreement provides that the Union acknowledges that it is responsible for all tax consequences of the Settlement assessed against the City or as determined by an appropriate government agency or authority. Under the agreement, this responsibility will include providing each Union member who receives any settlement distribution the appropriate tax documentation. The Union agrees that it will indemnify the City for any taxes for which the City is liable as a result of the settlement agreement.

You represent that the employees covered by the settlement are all members of the Retirement Plan, and that the Retirement Plan has determined that the settlement distributions are not subject to Retirement Plan contributions. You represent that the employees covered by the settlement are not included within the State agreement under section 218 of the Social Security Act ("section 218 agreement"), Retirement Plan participants are members of a retirement system for social security tax purposes, and neither the City nor the employees pay social security tax with respect to the employees' regular wages because of the employees' participation in the Retirement Plan.

Federal Income Tax Withholding

Section 3402(a) provides that, except as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the

Secretary. Section 3401(a) defines wages as all remuneration for services performed by an employee for his or her employer, with certain specific exceptions.

Under section 3401(d), the term “employer” generally means the person for whom an individual performs any service, of whatever nature, as the employer of such person. However, under section 3401(d)(1), if the person for whom the individual performs the services does not have control of the payment of the wages for such services, the term “employer” (except for purposes of section 3401(a)) means the person having control of the payment of such wages.

The employer under section 3401(d)(1) is responsible for income tax withholding generally, but is not the employer for purposes of section 3401(a), which defines wages for purposes of income tax withholding. As a result, the determination of whether remuneration is wages under section 3401(a) is made on the basis of the common law employer, even if another employer is the employer under section 3401(d)(1).

In Social Security Board v. Nierotko, 327 U.S. 358 (1946), the Supreme Court held that back pay awarded to an employee constitutes wages for purposes of the Social Security Act. Based on Nierotko, courts have held that awards that reflect compensation that would have been paid to the employee, including back pay or future pay, constitute wages subject to income tax withholding and Federal Insurance Contributions Act (FICA) tax withholding. For example, Rivera v. Baker West, Inc., 430 F.3d 1253, 1258-59 (9th Cir. 2005), held that awards for back pay and lost wages under Title VII of the Civil Rights Act of 1964 constitute wages subject to income tax withholding. Blim v. Western Elec. Co., 731 F.2d 1473, 1480 n. 2 (10th Cir. 1984), held that back pay is taxable to the plaintiffs and subject to income tax and FICA tax withholding. Also, Rev. Rul. 78-336, 1978-2 C.B. 255, holds that a court ordered back pay award paid to a former employee is wages in the year paid rather than in the year earned and is subject to income tax withholding at the rates in effect at the time the award is paid.

The settlement distributions here are in settlement of claims for unpaid wages and are in effect back pay that has consistently been held to be wages under section 3401(a). The payments represent remuneration for services performed by employees for the City and are wages for federal income tax withholding purposes.

Social Security taxes

FICA taxes are imposed on wages as defined in section 3121(a) of the Code. The term “wages” is defined in section 3121(a) as all remuneration for employment, unless specifically excepted. “Employment” is defined in section 3121(b) as including any service of whatever nature, performed by an employee for the person employing him or her, with certain exceptions. FICA taxes include the Old-Age, Survivors, and Disability Insurance Tax (social security taxes) and hospital insurance taxes (Medicare taxes). Social security taxes are imposed by sections 3101(a) (employee’s portion) and 3111(a)

(employer's portion). Medicare taxes are imposed by sections 3101(b) (employee's portion) and 3111(b) (employer's portion). The Additional Medicare Tax is imposed under section 3101(b)(2) and consists of the employee's portion only. Neither the FICA nor the FUTA provisions contain a definition of employer similar to the definition for income tax withholding purposes contained in section 3401(d)(1). However, Otte v. United States, 419 U.S. 43 (1974), holds that a person who is an employer under section 3401(d)(1) is also an employer for purposes of withholding of the employee FICA tax imposed under section 3101. Circuit courts have applied the Otte holding to conclude that the person having control of the payment of the wages under section 3401(d)(1) is also the employer for purposes of section 3111, which imposes the employer FICA tax, and for purposes of section 3301, which imposes the FUTA tax on employers. See, for example, In re Armadillo Corp., 561 F.2d 1382 (10th Cir. 1977).

Although the employer under section 3401(d)(1) is responsible for FICA tax withholding generally, the employee's common law employer is the employer for purposes of determining whether the remuneration is subject to FICA and FUTA. The settlement agreement relates to services performed in the employ of the City and therefore, the issue of whether such services constitute "employment" for purposes of the social security tax portion of the FICA is determined under section 3121(b)(7). Section 3121(b)(7) provides an exception from the definition of employment for service performed in the employ of a State or any political subdivision thereof, or any instrumentality of one or more of the foregoing which is wholly owned thereby, except that the paragraph shall not apply in the case of certain services. Generally, the exception provided by section 3121(b)(7) applies if the employee of the State, political subdivision, or instrumentality is a member of a retirement system of such State, political subdivision or instrumentality and if the employee is not covered under a section 218 agreement.

If an employee of a state, political subdivision, or instrumentality thereof is covered under an agreement under section 218 of the Social Security Act, the employee's remuneration is subject to social security taxes. See section 3121(b)(7)(E). When an employee is not covered under a section 218 agreement, the employee's remuneration is generally subject to social security taxes unless the employee is a member of a retirement system. Section 31.3121(b)(7)-2 of the regulations provides rules for determining whether an employee is a "member of a retirement system." These rules generally treat an employee as a member of a retirement system if he or she participates in a system that provides retirement benefits, and has an accrued benefit or receives an allocation under the system that is comparable to the benefits he or she would have received under Social Security. In the case of part-time, seasonal and temporary employees, this minimum retirement benefit is required to be nonforfeitable.

Section 31.3121(b)(7)-2(e)(2) of the regulations provides that a plan must provide a minimum level of benefits to an employee for the employee to qualify as a member of a

retirement system. Under section 31.3121(b)(7)-2(e)(2)(ii), a defined benefit retirement system maintained by a State, political subdivision or instrumentality thereof meets the requirements of section 31.3121(b)(7)-2(e)(2) with respect to an employee on a given day if and only if, on that day, the employee has an accrued benefit under the system that entitles the employee to an annual benefit commencing on or before his or her Social Security retirement age that is at least equal to the annual Primary Insurance Amount the employee would have under Social Security. For this purpose, the Primary Insurance Amount an individual would have under Social Security is determined as it would be under the Social Security Act if the employee had been covered under Social Security for all periods of service with the State, political subdivision or instrumentality, had never performed service for any other employer, and had been fully insured within the meaning of section 214(a) of the Social Security Act, except that all periods of service with the State, political subdivision or instrumentality must be taken into account (i.e., without reduction for low-earning years). Rev. Proc. 91-40, 1991-2 C.B. 694, provides safe harbor formulas for defined benefit retirement systems for purposes of meeting the minimum benefit requirement of the regulations.

You have represented that the Union's member-employees receiving the payments are members of the Retirement Plan, that the employees are not covered under the section 218 agreement between the State and the Social Security Administration, and that participants in the Retirement Plan are members of a retirement system for purposes of section 3121(b)(7)(F). If the employees receiving the settlement distributions qualify as members of a retirement system with respect to year c, then the settlement distributions made are not subject to social security taxes.

Medicare tax

Section 3121(u)(2) provides generally that remuneration for services paid to employees of states, political subdivisions, or instrumentalities thereof is subject to Medicare tax unless the continuing employment exception provided by section 3121(u)(2)(C) applies. Section 3121(u)(2)(C) generally applies if the employee has been continuously performing services for a state or local employer since March 31, 1986, if the service is not covered under a section 218 agreement, and if the service meets other specific rules set forth in section 3121(u)(2)(C).

Because the settlement distributions are remuneration for services performed in the employ of the City, the settlement distributions made by the Union are wages subject to Medicare tax unless the continuing employment exception applies. Thus, employee Medicare tax is required to be withheld and paid from the distributions and the employer Medicare tax applies to the distributions, unless the continuing employment exception under section 3121(u)(2)(C) applies.

FUTA

FUTA tax is imposed by section 3301 of the Internal Revenue Code on “wages,” as defined in section 3306(b). Section 3306(b) defines wages as all remuneration for employment, unless specifically excepted. Section 3306(c) defines “employment” as including any service of whatever nature, performed by an employee for an employer, with certain specific exceptions. Section 3306(c)(7) excludes from the definition of “employment” service performed in the employ of a State, or any political subdivision thereof, or in the employ of an Indian tribe or any instrumentality of any one or more of the foregoing which is wholly owned by one or more States or political subdivisions or Indian tribes.

The settlement is remuneration for services in the employ of the City, and thus the exception from employment for FUTA purposes provided by section 3306(c)(7) applies. Therefore, the settlement distributions made to member-employees are not subject to FUTA taxes.

Reporting of Settlement Distributions

Section 6051(a) and the regulations thereunder provide that Form W-2, Wage and Tax Statement, must be filed with respect to wages for services performed by an employee for an employer from which income tax, social security tax, or Medicare tax was withheld, or from which income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4.

Because the settlement distributions are wages subject to income tax withholding and Medicare taxes, Form W-2 should be used to report the payments.

Rulings

Accordingly, we conclude as follows with respect to the rulings requested:

- (1) The settlement distributions are wages subject to federal income tax withholding.
- (2) The settlement distributions are not subject to social security taxes provided the recipient was a participant in the Retirement Plan and qualified as a member of a retirement system under section 31.3121(b)(7)-2 with respect to services he or she performed in year c.
- (3) The settlement distributions are wages subject to Medicare tax unless the employee’s services for year c were covered by the continuing employment exception contained in section 3121(u)(2)(C).
- (4) The settlement distributions are not subject to FUTA tax because services for the City are excepted from employment for purposes of the FUTA.

(5) The settlement distributions are reportable on Form W-2.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting 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.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Lynne Camillo
Branch Chief, Employment Tax Branch 2 (Exempt
Organizations/Employment Tax/Government
Entities)
(Tax Exempt & Government entities)