

Part I

Section 3121.--Definitions

26 CFR 31.3121(a)-1: Wages.

(Also: 1221, 1222, 3306, 3401, 1.1221-1, 1.1222-1, 31.3306(b)-1, 31.3401(a)-1)

Rev. Rul. 2004-110

ISSUE

Whether an amount paid to an employee as consideration for the cancellation of an employment contract and relinquishment of contract rights is ordinary income, and wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source (Federal income tax withholding)?

FACTS

An employee performs services under a written employment contract providing for a specified number of years of employment. The contract does not provide for any payments to be made by either party in the event the contract is cancelled by mutual agreement. Before the end of the contract period, the employee and the employer agree to cancel the contract and negotiate a

payment from the employer to the employee in consideration for the employee's relinquishment of his contract rights to the remaining period of employment.

LAW

Ordinary Income

Section 1(h) of the Internal Revenue Code (Code) provides for maximum capital gains tax rates on net capital gain.

Section 1222(11) defines "net capital gain" as the excess of net long-term capital gain over net short-term capital loss. Under section 1222(3), the term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than one year.

Section 1221 provides that the term "capital asset" means property held by the taxpayer, with certain exclusions listed in section 1221(a)(1)-(8).

Section 1231 provides generally for capital gain or loss if there is net gain from the sale or exchange of property used in a trade or business and from certain involuntary conversions of business or investment property.

The United States Supreme Court has held that not everything that can be called "property" in the ordinary sense and that is outside the statutory exclusions in section 1221 or section 1231 qualifies as a "capital asset" under section 1221 or for purposes of section 1231, and that the term does not include certain claims or rights, the consideration for which essentially substitutes for ordinary income.

See Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134-136 (1960), Ct. D. 1853, 1960-2 C.B. 466, 468; Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265-67 (1958), Ct. D. 1823, 1958-1 C.B. 516, 518-19. Under this line

of Supreme Court decisions, it is settled that consideration received for the transfer or termination of a right to receive income for the past or future performance of services is taxable as ordinary income. See, e.g., Rothstein v. Commissioner, 90 T.C. 488, 493-94 (1988).

Wages

Sections 3101 and 3111 impose FICA taxes on "wages," as that term is defined in section 3121(a), with respect to "employment," as that term is defined in section 3121(b). FICA taxes consist of the Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on both the employer and employee. Sections 3101(a) and 3101(b) impose the employee portions of the social security tax and the Medicare tax, respectively. Sections 3111(a) and 3111(b) impose the employer portions of the social security tax and the Medicare tax, respectively.

The term "wages" is defined in section 3121(a) for FICA purposes as all remuneration for employment, with certain specific exceptions. Section 3121(b) defines "employment" as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Section 31.3121(a)-1(b) of the Employment Tax Regulations provides that the term "wages" means all remuneration for employment unless specifically excepted under section 3121(a). Section 31.3121(a)-1(c) provides that the name by which the remuneration for employment is designated is immaterial. Section 31.3121(a)-1(d) provides that generally the basis upon which the remuneration is paid is immaterial in determining whether the remuneration is wages. Section

31.3121(b)-3(b) defines employment as services performed by an employee for an employer, unless specifically excepted under section 3121(b).

Section 31.3121(a)-1(i) provides that remuneration, 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.

The FUTA taxation provisions are similar to the FICA provisions, except that only the employer pays the tax imposed under FUTA. See sections 3301 and 3306(b) and the regulations thereunder. Although there are differences in the statutory exceptions to what constitutes wages and employment, the general definitions of the terms “wages” and “employment” for FUTA purposes are similar to the definitions for FICA purposes. See sections 3306(b) and 3306(c).

Section 3402(a), relating to Federal income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term “wages” is defined in section 3401(a) for Federal income tax withholding purposes as all remuneration for services performed by an employee for his employer, with certain specific exceptions. Section 31.3401(a)-1(a)(2) provides that the name by which remuneration for services is designated is immaterial. Section 31.3401(a)-1(a)(3) provides that generally the basis upon which the remuneration is paid is immaterial in determining whether the remuneration is wages. Unlike the FICA and the FUTA,

the Federal income tax withholding provisions do not include a definition of employment.

Section 31.3401(a)-1(a)(5) provides that remuneration, 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.

Revenue Ruling 55-520, 1955-2 C.B. 393, concludes that an amount paid to an individual as a compromise settlement for the cancellation, before the normal expiration date, of a two-year employment contract is not wages for FICA and Federal income tax withholding purposes. The ruling further concludes that the payment is includible in the employee's gross income for Federal income tax purposes.

Revenue Ruling 58-301, 1958-1 C.B. 23, concludes that a lump sum payment received by an employee as consideration for his agreement to cancel the remaining period of a five-year employment contract during the second year of the term and to relinquish his contract rights is ordinary income, not capital gain, and is includible in his gross income in the year of receipt. The ruling further concludes that the payment is not subject to FICA and Federal income tax withholding.

Revenue Ruling 74-252, 1974-1 C.B. 287, concludes that payments made by an employer to an employee, following involuntary termination, under the provisions of a three-year contract are wages for FICA, FUTA, and Federal income tax withholding purposes. Under the terms of the contract, the employer

could terminate the relationship at any time, provided the employee was paid an amount equal to an additional six months salary. The ruling distinguishes Rev. Rul. 58-301 on the basis that these payments are in the nature of dismissal payments provided for under the terms of the contract, rather than as consideration for the relinquishment of interests the employee had in the employment contract.

Revenue Ruling 75-44, 1975-1 C.B. 15, involves an employer's payment to a railroad employee as consideration for the employee's agreement to perform a different type of work and refrain from asserting his employment rights acquired pursuant to his past service under a general contract of employment. The ruling concludes that the payment received by the employee is ordinary income in the taxable year of receipt and is "compensation" for purposes of the Railroad Retirement Tax Act (RRTA) and "wages" for purposes of Federal income tax withholding. This ruling distinguishes Rev. Rul. 58-301 on the basis that in Rev. Rul. 58-301 the lump sum payment was primarily in consideration of the cancellation of the employee's original contract rights rather than primarily in consideration of the past performance of services through which the relinquished employment rights were acquired.

ANALYSIS

The Code and regulations provide that amounts an employer pays an employee as remuneration for employment are wages, unless a specific exception applies. Sections 3121(a), 3306(b), and 3401(a) and sections 31.3121(a)-1(b), 31.3306(b)-1(b), and 31.3401(a)-1(a)(1) of the regulations. The

regulations also provide that the name by which the remuneration is designated is immaterial. Sections 31.3121(a)-1(c), 31.3306(b)-1(c), and 31.3401(a)-1(a)(2). Furthermore, the remuneration is wages even though at the time paid the relationship of employer and employee no longer exists. Sections 31.3121(a)-1(i), 31.3306(b)-1(i), and 31.3401(a)-1(a)(5).

The Code and the regulations also provide that any service of whatever nature performed by an employee for the person employing him is employment, unless a specific exemption applies. Sections 3121(b) and 3306(c) and sections 31.3121(b)-3(b) and 31.3306(c)-2(b).

Employment encompasses the establishment, maintenance, furtherance, alteration, or cancellation of the employer-employee relationship or any of the terms and conditions thereof. If the employee provides clear, separate, and adequate consideration for the employer's payment that is not dependent upon the employer-employee relationship and its component terms and conditions, the payment is not wages for purposes of FICA, FUTA, or Federal income tax withholding.

Under the facts presented in this ruling, the employee receives the payment as consideration for canceling the remaining period of his employment contract and relinquishing his contract rights. As such, the payment is part of the compensation the employer pays as remuneration for employment. The employee does not provide clear, separate, and adequate consideration for the employer's payment that is not dependent upon the employer-employee relationship and its component terms and conditions. Thus, the payment

provided by the employer to the employee is wages for purposes of FICA, FUTA, and Federal income tax withholding. This conclusion applies regardless of the name by which the remuneration is designated or whether the employment relationship still exists at the time the payment is made.

With respect to the application of FICA and Federal income tax withholding, Rev. Rul. 55-520 and Rev. Rul. 58-301 erred in their analysis by failing to apply the Code and regulations appropriately to the question of whether the payments made in cancellation of the employment contract were wages.

To qualify as capital gain, eligible for the reduced rates in section 1(h), a payment must be received in connection with a "sale or exchange" of "property," as those terms are used in sections 1221, 1222, and 1231. Under Gillette Motor, P.G. Lake, and the settled line of authority applying the Supreme Court's reasoning to compensation-related rights, consideration received for the transfer or termination of a right to receive income for the past or future performance of services is a substitute for ordinary income, taxable as such. The payment received by the employee in the present situation is a payment of this type, and for capital gains purposes is not a payment for property. It is therefore taxable to the employee as ordinary income.

With respect to the ordinary or capital character of a payment, the payments in Rev. Rul. 55-520, Rev. Rul. 58-301, Rev. Rul. 74-252, and Rev. Rul. 75-44 are ordinary income; in particular, the specific holdings to this effect in Rev. Rul. 58-301 and Rev. Rul. 75-44 remain correct.

Accordingly, Rev. Rul. 55-520 and Rev. Rul. 58-301 are modified and superseded. In addition, Rev. Rul. 74-252 and Rev. Rul. 75-44 are modified to the extent their holdings regarding FICA, FUTA, RRTA, and Federal income tax withholding rely on distinguishing Rev. Rul. 58-301.

HOLDING

An amount paid to an employee as consideration for cancellation of an employment contract and relinquishment of contract rights is ordinary income, and wages for purposes of FICA, FUTA, and Federal income tax withholding.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 55-520 and Rev. Rul. 58-301 are modified and superseded. Rev. Rul. 74-252 and Rev. Rul. 75-44 are modified.

APPLICATION

Under the authority of section 7805(b), the Service will not apply the position adopted in this ruling to any payment that an employer made to an employee or former employee before January 12, 2005, provided that the payment is made under facts and circumstances that are substantially the same as in Rev. Rul. 55-520 or Rev. Rul. 58-301.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Michael Swim and Elliot Rogers of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Mr. Rogers on (202) 622-6040 (not a toll-free call).