

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
October 8, 1999

Legend:

City Y =
Water District =
State X =
Date 1 =
Date 2 =
Date 3 =
Date 4 =

Dear Mr. _____ :

This is in reply to your request for a ruling submitted on behalf of the taxpayer, City Y, concerning the availability of the exception from Medicare taxes provided in section 3121(u)(2)(C) of the Internal Revenue Code (the Code) to former employees of the Water District.

FACTS

The Water District was created on Date 1 under the State X Water Code. On Date 2, the Water District became a subsidiary district of City Y. The Water District is a not-for-profit local government organization. Control and supervision of the Water District is vested solely in the City Y Council. The sources of funds used to operate the Water District are fees for service and property taxes. The Water District is financially accountable to City Y, and the City Y annual report includes the financial activities of the Water District as a component of City Y.

On Date 3, City Y entered into an agreement with the Water District which provided, in pertinent part, for the transfer of all Water District employees, below the level of the General Manager, to City Y employment. Upon adoption of the agreement

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on Date 4, all former Water District employees, except the General Manager,¹ became employees of City Y. Pursuant to the agreement, the Water District now contracts with City Y for the provision of water services. City Y and the Water District are separate entities. However, their governing boards are identical in that the members of the City Y Council and the Water District's Board of Directors are the same.

The former employees of the Water District transferred to City Y employment without interruption in service. The former Water District employees were given credit for seniority and retained all earned benefits and accrual rates as if all years of service at the Water District were at City Y.

Of the twenty-four employees of the Water District, who were transferred to City Y employment, six were hired by the Water District prior to April 1, 1986. You have represented that, pursuant to the "continuing employment exception," these six employees were exempt from Medicare tax while employed by the Water District.

LAW AND ANALYSIS

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."

Section 13205 of the Consolidated Omnibus Budget Reconciliation Act of 1985 amended section 3121(u) of the Code. In general, the amendment applies sections 3101(b) and 3111(b), the Medicare portion of the 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 subdivisions were not covered under the FICA, as their services were excepted from the term "employment" by section 3121(b)(7).

Section 3121(u)(2) of the Code provides a limited exception to section 3121(b)(7), subjecting certain state and local government employees to Medicare taxes, but not old-age, survivors, and disability insurance taxes. Under section 3121(u)(2), except in limited circumstances, services performed by state and local government employees hired after March 31, 1986, that are not subject to a section 218 agreement, are "employment" for Medicare tax purposes.

¹ The General Manager has since retired; his status was not raised in the ruling request.

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Under section 3121(u)(2)(C) of the Code, services performed by state or local government employees hired on or before March 31, 1986, continue to be exempt from Medicare taxes (if section 3121(b)(7) otherwise applies), provided that such employees were performing regular and substantial services for pay on or before that date, were employed in good faith on that date, had been hired for purposes other than avoiding the Medicare taxes, and have not at any time since that date experienced a termination of the employment relationship with the employer. This is referred to as the “continuing employment exception.”

Code section 3121(u)(2)(D) provides that, for purposes of the continuing employment exception, all agencies and instrumentalities of a State shall be treated as a single employer, and all agencies and instrumentalities of a political subdivision of a State shall be treated as a single employer.

Rev. Rul. 86-88, 1986-2 C.B. 172, provides guidance concerning the continuing employment exception and the applicability of the Medicare tax. Rev. Rul. 86-88 provides, at Q&A 7, that an employee hired before April 1, 1986, by a state employer, who transfers after March 31, 1986, to another state employer of that state may qualify for the continuing employment exception, provided that transfer was made without a termination of the employee’s overall employment relationship with that state. The same rule applies to an employee hired before April 1, 1986, by a political subdivision employer, who transfers after March 31, 1986, to another political subdivision employer of that political subdivision.

Based on the information furnished, we have concluded that the Water District is an agency or instrumentality of City Y. Therefore, pursuant to Code section 3121(u)(2)(D), City Y and the Water District are treated as a single employer for purposes of the continuing employment exception. Moreover, pursuant to Rev. Rul. 86-88, where, as here, employees who were hired before April 1, 1986 by a political subdivision employer (the Water District) who transfer after March 31, 1986, to another political subdivision employer (City Y) of that political subdivision may qualify for the continuing employment exception, provided that transfer was made without a termination of the employee’s overall employment relationship with the political division.

Consequently, we hold that the six Water District employees hired prior to April 1, 1986, and previously entitled to the continuing employment exception to Medicare taxes of Code section 3121(u)(2)(C) continue to be eligible for such exception following transfer to City Y employment.

This holding is based on the representation that the six employees who are the subject of this ruling were entitled to the continuing employment exception prior to the transfer from employment with the Water District to employment with City Y, that such employees are not covered by a section 218 agreement, and that there has been no other termination of the employees’ employment relationship.

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We express no opinion on the tax consequences of the above transaction under any other section of the Code. 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.

Sincerely,

Jerry E. Holmes
Chief, Branch Two
Office of the Associate
Chief Counsel (Employee
Benefits and Exempt Organizations)