



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DIRECTOR, BROOKHAVEN SERVICE CENTER  
DISTRICT COUNSEL, BROOKLYN

FROM: Assistant Chief Counsel by Patricia M. McDermott (Employee  
Benefits and Exempt Organizations) CC:EBO

SUBJECT: FICA Taxes On Pension Settlement Payments

This memorandum responds to your communication dated December 6, 1999. The advice herein is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUE

Whether cash payments by employers to employees in settlement of a suit by a class of employees for additional credit under their qualified pension plan for services performed prior to 1984 are wages for purposes of the Federal Insurance Contributions Act (FICA).

CONCLUSION

The payments are wages for FICA tax purposes.

FACTS

Under the example facts, a class of employees brings suit against an employer seeking additional service credit under a qualified pension plan, which came into existence many years before 1983. In some cases, the claim is part of a suit alleging employment discrimination. In other cases, the suit arises from employees' claims that a particular pension plan operated in such a manner that the terms of the plan unfairly denied them service or that they were not given sufficient notice of the effect of an election on their service credit. The service credit at issue relates

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to years prior to 1984. Under the example facts, the case is settled by the employer making a cash payment directly to the employee. It is assumed for purposes of this case that none of the amounts are excludable from gross income under section 104(a)(2).

### LAW AND ANALYSIS

Under section 3101 and 3111, FICA taxes apply to "wages." Section 3121(a) provides that for purposes of the FICA the term "wages" means "all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash" unless specifically excepted. Employment is defined as "any service, of whatever nature, performed ... by an employee for the person employing him." Sections 3121(b). "Taken together, subsections (a) and (b) of § 3121 define 'wages,' therefore, as 'all remuneration' for 'any service.'" STA of Baltimore - ILA Container Royalty Fund v. United States, 621 F.Supp. 1567, 1570 (D.Md. 1985), aff'd, 804 F.2d 296 (4th Cir. 1986).

Section 3121(a)(5)(A) excepts from the definition of wages, for FICA purposes, any employer payment made to, or on behalf of, an employee or his beneficiary from or to a trust described in section 401(a) which is exempt from tax under section 501(a) at the time of such payment unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust.

Treas. Reg. Section 31.3121(a)-1(i) provides that remuneration for employment, 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.

Treas. Reg. Section 31.3121(a)-1(d) provides that generally, the basis upon which remuneration is paid is immaterial in determining whether the remuneration constitutes wages for FICA purposes.

The seminal case on the issue of the wage status of back pay awarded for an employer violation of a employees' rights statute is Social Security Board v. Nierotko, 327 U.S. 358 (1946). In that case the Supreme Court held that "back pay" awarded to an employee who was found to have been wrongfully discharged under the National Labor Relations Act (NLRA) was wages for purposes of the Social Security Act. The basic definition of wages under the Social Security Act for the years at issue in Nierotko was similar to the current definition. The NLRA allowed the National Labor Relations Board to provide back pay to workers who were wrongfully discharged because of "unfair labor practices." The Social Security Board argued that the payments were not wages because the petitioner had performed no service during the time for which he was awarded back pay. The

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Court noted the broad definitions of wages as “all remuneration for employment” and employment as “any service ... performed ... by an employee for his employer” under the Social Security Act. The Court stated as follows with respect to the definition of “employment” (327 U.S. at 365-66):

The very words “any service ... performed ... for his employer,” with the purpose of the Social Security Act in mind, import breadth of coverage. They admonish us against holding that “service” can be only productive activity. We think that “service” as used by Congress in this definitive phrase means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer.

Although Nierotko directly concerned whether the back pay was included in “wages” for purposes of benefits under the Social Security Act, the decision applies to interpretations of the FICA counterpart because of the similar language in the FICA definitions of “wages” and “employment”. See I.R.C. §3121(a) and (b). The Supreme Court recognized the congruity of the FICA definition and the Social Security Act definition in that it specifically dealt with and rejected previous Internal Revenue Service rulings holding that back pay provided under the NLRA was not wages for FICA tax purposes. See 327 U.S. at 366-369.

Many recent cases have also recognized the breadth of the definition of wages under the FICA. In Associated Electric Cooperative Inc. v. United States, 42 Fed. Cl. 867 (1999), the court held that certain termination payments paid pursuant to a voluntary “early out” plan were wages subject to FICA. The court stated, at 42 Fed. Cl. 872: “The notion of an “employer-employee” relationship continues to be recognized as the touchstone for determining if a particular payment is subject to FICA taxation.” See also Abrahamsen v. United States, 44 Fed. Cl. 260 (1999); Mayberry v. United States, 151 F.3d 855, 860 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204, 209 (4th Cir. 1997); Lane Processing Trust v. United States, 25 F.3d 662 (8th Cir. 1994); and Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund v. United States, 64 F.3d 245 (6th Cir. 1995).

In four recent cases, four different circuits considered the income tax and FICA tax status of payments made to settle a class action law suit brought against the Continental Can Corp. for violation of ERISA. In the class action suit, the plaintiffs claimed that Continental Can maintained a systematic plan of terminating employees before they qualified for certain pension plan benefits. The class action suit was settled with the payment by Continental Can into a settlement fund. The settlement fund was administered by a Special Master who distributed proceeds to the class members based on several factors including each individual’s claimant’s years of service, years to retirement, expected earnings if he or she had not been terminated by Continental Can, and actual earnings after termination. These cases dealt with claims under ERISA that were made before the Supreme Court’s decision

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in Mertens v. Hewitt Associates, 508 U.S. 248 (1993), holding that damages for ERISA violations were strictly limited to equitable remedies. Two of the circuits held that the entire amount of the settlement payments were wages for FICA purposes. Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204 (4th Cir. 204). Two other circuits held that a portion of the settlement payments were not wages for FICA tax purposes. Dotson v. United States, 87 F.3d 682 (5th Cir. 1996); Gerbec v. United States, 164 F.3d 1015 (6th Cir. 1999).<sup>1</sup> However, all four circuits agreed that to the extent that the settlement payments were back pay, the payments were wages for FICA tax purposes.

Based on the above authority, cash payments made in lieu of pension credits for prior service are remuneration for past services performed for the taxpayer or a predecessor. The payments arise from the employment relationship with the employer. As such, they are remuneration for employment and are wages for FICA tax purposes unless an exception applies.

The exception provided by section 3121(a)(5)(A) does not apply because the payments are not made from an exempt trust of a qualified plan as required by the statute. But see, LTV Steel Co. v. United States, 42 Fed. Cl. 65 (1998), appeal pending (Fed. Cir. 1999).

Because the payments are in lieu of service credit for services performed before 1984, an issue arises whether the payments qualify for the retirement exceptions provided by sections 3121(a)(2), 3121(a)(3), and 3121(a)(13) before these sections were amended in 1983. Before the Social Security Amendments of 1983, Pub. L. No. 98-21, , I.R.C. section 3121(a) provided exceptions from the definition of "wages" for certain payments made upon or because of an employee's retirement. These exceptions were contained in sections 3121(a)(2)(A), 3121(a)(3), and 3121(a)(13). Section 3121(a)(2)(A) provided an exception for "the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) made to, or on behalf of, an employee or any of his dependents under a plan or system which makes provision for his employees generally or for a class or classes of his employees (A) on account of retirement...." Section 3121(a)(3) excepted any payment made to an employee on account of retirement. Section 3121(a)(13) provided an exception for "any payment or series of payments by an employer to an employee or any of his dependents which is paid -- (A) upon or after the termination of an employee's employment relationship because of ... (iii) retirement after attaining an age specified in the plan referred to in subparagraph (B) or in a pension plan of the employer, and (B) under

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<sup>1</sup> We note that the decisions in Dotson and Gerbec were based on the settling parties and the Special Master relying on certain authority existing before the issuance of Mertens that could be read as contrary to Mertens.

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a plan established by the employer which makes provision for his employees generally or a class or classes of his employees, other than a payment or series of payments which would have been paid if the employee's employment relationship had not been so terminated."

The exception for plan payments on account of retirement contained in section 3121(a)(2)(A) was eliminated by section 324 of the 1983 Amendments. In addition, section 324 also deleted the exception for payments on account of retirement contained in section 3121(a)(3) and the exception for non-disability retirement payments contained in section 3121(a)(13).

Section 324 of the 1983 Amendments also added section 3121(v) to the Code. Final regulations under section 3121(v) were published on January 29, 1999 (64 FR 4547) and April 1, 1999 (64 FR 15687). See section 31.3121(v)(2)-1 of the regulations. Section 3121(v)(2)(A) provides that any amount deferred under a nonqualified deferred compensation plan shall be taken into account for purposes of the FICA as of the later of -- (i) when the services are performed, or (ii) when there is no substantial risk of forfeiture of the rights to such amount. Section 3121(v)(2)(B) provides that any amount taken into account as wages by reason of section 3121(v)(2)(A) shall not thereafter be treated as wages for purposes of the FICA. Section 3121(v)(2)(C) provides that for purposes of section 3121(v), the term "nonqualified deferred compensation plan" means any plan or other arrangement for deferral of compensation other than a plan described in section 3121(a)(5).

The effective date provisions for section 324 of the 1983 Amendments are contained in section 324(d). Section 324(d)(1) provides that, except as otherwise provided by section 324(d), the amendments made by section 324 to the FICA shall apply to remuneration paid after December 31, 1983.

However, section 324(d)(4) of the 1983 Amendments provides that, in the case of an agreement in existence on March 24, 1983, between a nonqualified deferred compensation plan (as defined in section 3121(v)(2)(C) of the Code) and an individual, the amendments made by section 324 to the FICA shall apply with respect to services performed by such individual after December 31, 1983.

Section 2662(f)(2)(C) of the Deficit Reduction Act of 1984 (DEFRA), Pub. L. 98-369, amended section 324(d)(4) of the 1983 Amendments by adding a sentence stating that "[f]or purposes of ...[section 324(d)(4)], any plan or agreement to make payments described in paragraph (2), (3), or (13)(A)(iii) of section 3121(a) of such Code (as in effect on the day before the date of enactment of the ...[1983 Amendments]) shall be treated as a nonqualified deferred compensation plan."

Because the service credit sought by the plaintiffs in these example cases was not provided under the terms of an agreement existing on March 24, 1983, the

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transition rule provided by section 324(d)(4) does not apply. Each of these cases is premised on the fact that in 1983, the qualified pension plan between the employer and the individual employee illegally did not provide for certain service credit. In certain cases under the example, the plaintiffs may be arguing that the terms of the qualified plan (or its predecessors) as it existed in 1983 were in violation of the Employee Retirement Income Security Act (ERISA). In such cases, the plaintiffs' argument is not based on an employer's violation of the terms of the pension plan existing in 1983 but the fact that the 1983 pension plan was itself in violation of ERISA. In other cases, the plaintiffs are arguing that the terms of the qualified pension plan did not provide them benefits because of workplace discrimination against them and the plaintiffs did not earn the salary that they would have earned absent the discrimination. In either case, the qualified plan as it existed in 1983 did not provide for the particular benefits that the cash payments are in lieu of under the settlement agreement. Thus, in these cases, the cash payments are not provided for under any agreement in existence in 1983. Therefore, the FICA taxation of these payments is not governed by the transition rule provided by section 324(d)(4) of the 1983 Amendments. Cf. LTV Steel Co. v. United States, 42 Fed. Cl. 65.

Also, the question arises whether the qualified pension plan in these example cases was nonqualified deferred compensation plan in existence on March 24, 1983, and therefore, the payments in lieu of service credit can be covered by the section 324(d)(4) transition rule. The interpretation that a qualified plan is a nonqualified plan for purposes of the transitional rule does not appear to be consistent with the fact that the amendments affected by the provision related to exceptions provided for nonqualified plans. The amendment by the DEFRA to the definition of nonqualified deferred compensation for purposes of section 324(d)(4) of the 1983 Amendments clarified the definition of nonqualified deferred compensation plan, but did not eliminate the specific reference to section 3121(v)(2)(C) of the Code in section 324(d)(4). Section 3121(v)(2)(C) provides that the term "nonqualified deferred compensation plan" means "any plan or other arrangement for deferral of compensation other than a plan described in subsection (a)(5)." Section 3121(a)(5) provides exceptions from wages for contributions and benefits paid from various types of qualified plans; section 3121(a)(5)(A) specifically provides excepts contributions and benefits from trusts described in section 401(a) which are exempt from tax under section 501(a) at the time of the payment into the fund (i.e., qualified pension plans). Thus, qualified plans are specifically excepted from the definition of "nonqualified deferred compensation plan" by the language "other than a plan described in subsection (a)(5)."

In examining the definition of nonqualified deferred compensation plan in section 3121(v)(2)(C), it is clear that part of the definition is somewhat ambiguous and part is unambiguous. The ambiguous part is "any plan or arrangement for the deferral of compensation"; that language is susceptible of different interpretations and

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questions had been raised whether certain early retirement incentive plans would satisfy the definition. A major part of the regulations under section 3121(v) is devoted to explaining what constitutes a plan or arrangement for the deferral of compensation.

The somewhat ambiguous language at the beginning of section 3121(v)(2)(C) concerning a plan or arrangement for the deferral of compensation should be contrasted with the unambiguous part of the definition of nonqualified deferred compensation plan: the part specifically excluding qualified plans, "other than a plan described in section (a)(5)." If the DEFRA amendment to the effective date provisions was intended to convert qualified plans to nonqualified plans, Congress could easily have deleted the parenthetical contained in the first sentence of section 324(d)(4) of the 1983 Amendments. Our interpretation provides an interpretation of the DEFRA amendment that is not inconsistent with the first sentence of section 324(d)(4); on the other hand, the interpretation that this transition rule applies creates an inconsistency within the provisions of section 324(d)(4), in addition to being on its face contradictory. It would be incongruous to hold that the obligation to pay qualified benefits provided under a qualified deferred compensation plan should be treated as a nonqualified deferred compensation plan when the specific references in the DEFRA amendment were to provisions that describe nonqualified arrangements (i.e., old section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii)).

The interpretation that a qualified plan is a nonqualified deferred compensation plan renders the parenthetical reference to section 3121(v)(2)(C) in the first sentence of section 324(d)(4) of the 1983 Amendments nugatory. Our interpretation that the definition of nonqualified deferred compensation plans does not include qualified plans is consistent with the idea that the provision was added to resolve the ambiguous language in section 3121(v)(2)(C) for purposes of the transition rules. Qualified plans were not intended to be transformed into nonqualified plans under the amendment to the section 324(d)(4) transition rules.

In summary, the payments do not qualify for the transition rule exception for agreements in existence on March 24, 1983, between an individual and a nonqualified deferred compensation plan because the qualified plan is not a nonqualified deferred compensation plan for purposes of the transition rules and because there was no agreement to make these settlement payments until the year that the settlement agreement was reached between the corporation and the plaintiffs, which was after March 24, 1983. Because the payments are remuneration for past services and no exception from the definition of wages applies, the payments are wages for FICA tax purposes.

Please call if you have any further questions.