



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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The Honorable Johnny Isakson
United States Senate
One Overton Park
3625 Cumberland Blvd., Suite 970
Atlanta, Georgia 30399

Attention:

Re:

Dear Senator Isakson:

This letter is in response to your inquiry on behalf of your constituent, _____, who wrote about the FICA taxation of a settlement amount he received from his former employer in lieu of retiree health care coverage. In particular, _____ wants to know the legal reasons why the settlement amounts were subject to FICA withholding.

Sections 3101 and 3111 of the Internal Revenue Code (Code) impose taxes under the Federal Insurance Contributions Act (FICA) on "wages" as that term is defined in section 3121(a). FICA taxes consist of Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance (Medicare) tax. These taxes are imposed on both the employer and the employee. The employee's portion of the FICA taxes must be collected by the employer by deducting the amount of tax from wages as and when paid. (Code section 3102(a)).

The term "wages" for FICA purposes includes all remuneration for employment, subject to certain specified exceptions. (Code section 3121(a)). The Employment Tax Regulations (Regulations) provide that remuneration for employment, unless specifically excepted, constitutes "wages" even though at the time paid the recipient is no longer an employee. (Regulations section 31.3121(a)-1(i)).

The law excludes from the definition of wages payments an employer makes under a plan or system that provides sickness or accident disability benefits to employees and their dependents. (Code section 3121(a)). The Regulations provide that "[t]he term "wages" does not include the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund to provide for such payment) made to, or on behalf of, an employee or any of his dependents under a plan or system established by an employer which makes provision for his employees ... on account of ... medical or hospitalization expenses in connection with sickness or accident disability of an employee or any of his dependents...." (Regulation section 31.3121(a)(2)-1(a)). However, amounts paid directly to employees in lieu of health coverage are not subject to this exception.

We use the "origin of the claim" doctrine to determine the proper tax treatment of a court award or settlement. The doctrine focuses on the nature of the claim that led to the award or settlement. Economic recoveries of back pay arising out of an employment relationship are includable in income and subject to FICA withholding, even if the amounts recovered are paid in lieu of nontaxable fringe benefits. See *e.g. United States v. McKean*, 33 Fed.Cl. 535 (1995).

For example, Revenue Ruling 75-241, 1975-1 C.B. 316, describes an employee who was paid a cash amount in lieu of certain health and welfare benefits. The revenue ruling concluded that the payments were wages for FICA purposes because "the payments are attributable to service performed by the employees for their employer, although the employers paid the amounts in discharge of a requirement of a Federal statute that minimum fringe benefits in the form of health and welfare benefits be provided." A significant factor in that ruling is that the employee had complete control over the disposition of the funds he received in lieu of certain health and welfare benefits, and the payor of the funds had no legal or contractual obligation to, and did not, verify that the employees used the cash payments to purchase health and welfare benefits. Thus, even though contributions an employer makes under a plan or system that provides sickness or accident disability benefits to employees are generally excepted from FICA withholding, cash payments an employer makes directly to employees in lieu of such contributions are wages subject to FICA withholding.

I hope this information is helpful. If you have any questions or need further assistance, please contact me or _____ of my staff at () _____.

Sincerely,

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