



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

February 29, 2008

Number: **INFO 2008-0006**

Release Date: 3/28/2008

UIL: 3121.01-14

CONEX-106508-08

The Honorable Saxby Chambliss  
United States Senate  
300 Mulberry Street, Suite 502  
Macon, Georgia 31201

Attention:

Dear Senator Chambliss:

This letter is in response to your inquiry dated January 23, 2008, on behalf of your constituent, . wrote about the taxation under the Federal Insurance Contributions Act (FICA) of a settlement amount he received from his former employer in lieu of retiree health care coverage. In particular, wants to know the reasons why the settlement amounts he received following the employer's bankruptcy were subject to FICA tax withholding when those amounts were paid for lost medical benefits and did not represent "earned wages."

Sections 3101 and 3111 of the Internal Revenue Code (the Code) impose FICA taxes 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 employer must collect the employee's portion of the FICA taxes by deducting the amount of tax from wages as and when paid (Section 3102(a) of the Code).

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

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 (Section 3121(a) of the Code). 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....” (Section 31.3121(a)(2)-1(a) of the Regulations). 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. *United States v. Burke*, 504 U.S. 229 (1992). Economic recoveries of back pay arising out of an employment relationship are includable in income and subject to FICA tax 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 payment 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 \_\_\_\_\_ of my staff at ( ) \_\_\_\_\_.

Sincerely,

Nancy J. Marks  
Division Counsel/Associate Chief Counsel  
(Tax Exempt & Government Entities)