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Person To Contact:
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Telephone Number:

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August 30, 2011

Legend

Provider =

Agency M =

Date X =

Date Y =

Year Z =

Improper Personnel Action =

Dear :

This is in reply to your request for a private letter ruling concerning the amount of a back pay award that is includible in the wages of employees for purposes of the Federal Insurance Contributions Act (FICA) and federal income tax withholding.

The Provider is a shared services payroll provider that provides payroll processing services to various Federal Government agencies, including Agency M. Employees of Agency M asserted a claim under the Back Pay Act (5 U.S.C. § 5596) that they were underpaid because of the Improper Personnel Action on Date X. The Back Pay Act provides awards to Federal employees “who ... have been affected by an unjustified or unwarranted personnel action which has resulted in the withdrawal or reduction of all or

part of the pay, allowances, or differentials of the employee....” 5 U.S.C. § 5596(b)(1). In such a case, the employee:

is entitled, on correction of the personnel action, to receive for the period for which the personnel action was in effect -- (i) an amount equal to all or any part of the pay, allowances, or differentials, as applicable which the employee normally would have earned or received during the period if the personnel action had not occurred, less any amounts earned by the employee through other employment during that period....
5 U.S.C. § 5596(b)(1)(A)(i).

In determining the back pay award, there was taken into account the period during Year Z between Date X and Date Y in which the employees received pay that was greater than the amount they would have received absent the Improper Personnel Action. The excess of the amount they actually received in Year Z between Date X and Date Y over the amount that they would have received for that period absent the Improper Personnel Action is referred to as the “excess pay”. From Date Y to the present, the employees received pay that was less than the pay they would have received absent the Improper Personnel Action (the difference between the amount they should have received for the period from Date Y to the present absent the Improper Personnel Action and the amount they actually received for that period is referred to as the “gross back pay”). In computing the employees’ recovery under the Back Pay Act, the gross back pay was reduced by the excess pay under the formula used to calculate the back pay award under the Back Pay Act. In calculating the amount of wages for Federal tax purposes, the Provider determined the amount of the underpayment for the period from Date Y to the present (the pay that should have been paid less the pay that was actually paid, i.e., the gross back pay) and treated that amount as the wages of the employee. The issue in this ruling request is whether the Provider correctly determined the wages of the employees for federal employment tax purposes.

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided, gross income means all income from whatever source derived.

Section 3402(a), concerning federal income tax withholding, provides that every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. Section 3401(a) provides that the term “wages,” for purposes of income tax withholding, means all remuneration for services performed by an employee for his employer, with certain exceptions not relevant here.

Federal Insurance Contributions Act (FICA) taxes are imposed on “wages” paid with respect to “employment” as those terms are defined in Code section 3121(a) and (b) respectively. FICA taxes consist of the Old Age Survivors and Disability Insurance tax (OASDI, or social security tax) and the hospital insurance tax (Medicare tax). These

taxes are paid by employers and employees. Section 3101(a) and (b) imposes the employee portions of the social security tax and Medicare tax. Section 3102(a) provides that the employee portion is collected by the employer by deducting the amount of the tax from the wages as and when paid. Section 3111(a) and 3111(b) imposes the employer portions of the social security tax and Medicare tax. The taxes are imposed on wages as that term is defined in section 3121(a). Wages is defined in section 3121(a) as all remuneration for employment, unless specifically excepted.

A cash basis taxpayer is ordinarily taxable in each year on all income received in the year under a claim of right and without restriction as to its use. North American Consolidated v. Burnet, 286 U.S. 417 (1932). Thus, in Rev. Rul. 70-177, 1970-1 C.B. 214, the amount of an erroneous salary payment received by a federal employee was “wages” subject to income tax withholding, and therefore, to the extent there has been no repayment of such amount by the employee within the same year, the Form W-2, Wage and Tax Statement, must reflect the full amount received by the employee in that year.

Rev. Rul. 67-350, 1967-2 C.B. 58, which addresses the income tax treatment of a reduction in military retirement pay to offset a previously received lump-sum readjustment payment, holds that only the remainder of the retired reservist’s military retirement pay is includible in the retiree’s gross income.

Rev. Rul. 80-9, 1980-1 C.B. 11, holds that a taxpayer who had amounts withheld from his disability pay to repay a lump-sum readjustment payment is considered as never having received the amounts withheld.

Rev. Rul. 2002-84, 2002-2 C.B. 953, considers the amount required to be treated as a distribution in a year in which payments made to an individual by a qualified retirement plan described in section 401(a) are reduced because, in a prior year, the individual received payments in excess of the amounts due to the individual.

Under Situation (1) of Rev. Rul. 2002-84, a former employee (Employee D) received \$36,000 as benefits in the form of a straight life annual annuity from a qualified defined benefit plan in 2001 and included the \$36,000 in gross income in 2001. In June 2002, it was determined that Employee D’s annuity benefit had been miscalculated and the annuity payment for 2001 should have been \$35,000. Under the administrative procedures of the plan, which are in accordance with the relevant correction procedures of the Employee Plans Compliance Resolution System (EPCRS), erroneous payments from the plan can be corrected by recouping the entire excess payment made in 2001 from Employee D’s remaining benefit payments for 2002. Thus, Employee D’s annuity benefits for 2002 of \$35,000 are reduced to \$33,900 to reflect the excess benefit amounts that were paid from the plan to Employee D during 2001.

Under Situation (2) of Rev. Rul. 2002-84, Employee E retired in 1992 and started to receive an annual straight life annuity of \$14,000 from a qualified plan. In November 2002, it was determined that Employee E's annuity benefit had been miscalculated and that the annual payment for 1992 through 2001 should have been \$13,000. Thus, the plan overpaid Employee E by \$1,000 per year for 10 years. Employee E included these amounts in gross income in the years received. Under the administrative procedures of the plan, which are consistent with EPCRS, the administrator of the plan determines that to recoup the overpayment, future payments should be reduced \$900 annually for life commencing in 2002. The plan adjusts Employee's annuity accordingly so that Employee E's annual straight life annuity benefit of \$13,000 is reduced for 2002 and subsequent years to \$12,100 to reflect the excess benefit amounts (increased by interest) that were paid from the plan to Employee E.

In Situation (3) of Rev. Rul. 2002-84, the facts are the same as in Situation (1) of the ruling, except that the benefit was paid to Employee F in a single sum distribution in 2001. The amount of the single sum distribution exceeded the amount that was due Employee F by \$2,000. Employee F included the entire amount of the single sum distribution in gross income in 2001. In 2002, the plan's administrator discovered the overpayment to Employee F. Pursuant to the plan's procedures, the administrator of the plan notified Employee F of the overpayment and demanded repayment with appropriate interest. In 2001, Employee F repaid \$2,120 (the \$2,000 overpayment plus \$120 interest) to the plan.

Rev. Rul. 2002-84 notes that sections 402(a) and 403(a) specifically address the tax treatment of distributions from qualified retirement plans. Under sections 402(a) and 403(a), amounts payable from a qualified retirement plan are included in gross income of the participant in the taxable year of distribution. The amounts are taxable to a distributee at the time of receipt, even though the distributee may be later obligated to repay amounts attributable to a plan overpayment in subsequent taxable years, either by direct payment or by payment reduction. Consequently, Rev. Rul. 2002-84 holds that, in Situations (1), (2), and (3), the amounts attributable to a plan overpayment are distributions taxable under section 402(a) in the year of receipt.

Rev. Rul. 2002-84 holds that in the years after the year of the plan overpayment, under the facts presented in Situations (1) and (2), only the amounts received by the distributee after the plan's required reduction to recoup an earlier plan overpayment are included in the distributee's gross income in the taxable year of distribution. The ruling states that this holding is consistent with Rev. Ruls. 67-350 and 80-9, under which taxpayers did not include in income withheld military retirement pay that was used to offset amounts previously received as a lump-sum readjustment pay for reserve officers. Consequently, the qualified retirement plan participants in Situations (1) and (2) who received distributions that included overpayments, and included the full amount of these distributions in gross income in the year of distribution, are in subsequent years only required to treat as distributions taxable under section 402(a) amounts distributed

by the plan after offset or adjustment to correct for the plan overpayments. The ruling also notes that the participants in Situations (1) and (2) are not entitled to take loss deductions under section 165(a) with respect to the offsets.

Rev. Rul. 2002-84 also states that, in contrast to Situations (1) and (2), in Situation (3), the overpayment is not recouped by a reduction in the amount of benefits paid to a participant but instead is repaid by the taxpayer directly in a single sum payment. For overpayments repaid to a qualified retirement plan in the same taxable year as the overpayment, the amount repaid reduces the taxable amount received as a distribution by the participant from the plan in the taxable year. For overpayments repaid to a qualified retirement plan in a taxable year or years subsequent to the year of the overpayment, a participant would be entitled to a deduction under section 165(a) because the amount of the plan overpayment is attributable to compensation for services rendered to the employer.

In the instant case, the Provider treated the gross back pay as wages with a repayment of the erroneous overpayments in Year Z because it viewed the employees as entitled to the gross back pay for the period of the Improper Personnel Action. Interest on the back pay was calculated based on the amount of the gross back pay without reduction for the repayment of overpaid wages.

The Back Pay Act is a remedial statute enacted to make employees whole for losses they suffer due to an unjustified personnel action. See Mattern v. Department of the Treasury, 291 F.3d 1366 (Fed. Cir. 2002). The Back Pay Act does not authorize a federal employer to recover independently an overpayment of pay it makes to employees. The amount that employees can recover under the Back Pay Act is limited to the amount that they were underpaid as a result of the unjustified personnel action, and thus the amount of any payments (including overpayments) they received as a result of the unjustified personnel action reduces the amount that the employee is paid as part of the remedial payment procedure. To assure that employees are not made more than whole, all payments received during the period of the unwarranted personnel action are offset against the amount employees should have been paid during the period to determine the amount to be paid under the Back Pay Act.

The amount of the back pay in this case was calculated by adding up the total amount of pay the employee should have received during the relevant period. However, to assure that the employees were not made more than whole, the amount of the award could not include pay the employees had actually received during the relevant period. The back pay under the Back Pay Act was calculated by first, determining the pay and allowances the employees would have received for the period from the date of the Improper Personnel Action on Date X to the present but for the Improper Personnel Action; and second, deducting from that amount the pay and allowances the employees actually received for the same period. Affected Agency M Employees were then paid the difference.

Under the Back Pay Act, the employees are not required to return to their employer excess pay they received during Year Z. Rather, in accordance with the Back Pay Act, the employees received awards to compensate them for their lost pay. Thus, the employees' accession to wealth, gross income under section 61, and wages under sections 3121 and 3401, is the difference between the pay and allowances they would have received from Date X to the present less the pay and allowances the employees actually received during that period. This is the amount that compensated the employees for their economic injury. Under the Back Pay Act, the employees are entitled to receive only the "gross back pay" less the "excess pay".

This result is consistent with Rev. Rul. 67-350, Rev. Rul. 80-9, and Situations (1) and (2) of Rev. Rul. 2002-84. As with the reduction in military retirement pay and disability pay to offset a previously received lump-sum readjustment payment in Rev. Rul. 67-350 and Rev. Rul. 80-9, respectively, the amount actually paid to the employees in the year of the back pay award is the employees' gross income and wages, not the amounts that were never paid because of the reductions for previously paid amounts.

Accordingly, based strictly on the facts of this case involving a resolution of a claim under the Back Pay Act, we conclude that the method used by the Provider of including the gross back pay in gross income and wages incorrectly calculated the amounts to be reported as income and wages on Form W-2 for income tax withholding and FICA tax purposes (subject to the maximum wage base with respect to social security taxes). We do not express an opinion whether a transaction involves a reduction or repayment of salary for federal tax purposes in situations not involving the Back Pay Act.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

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