

Office of Chief Counsel
Internal Revenue Service

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memorandum

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to: District Counsel
Brooklyn CC:NER:BRK

from: Assistant Chief Counsel
(Employee Benefits and Exempt Organizations)

subject: Significant Service Center Advice
Re: Wage Overpayment Taxability

This responds to your request for technical assistance dated March 16, 1998, in connection with questions posed by the Brookhaven Service Center concerning the federal tax consequences of repayments of erroneous salary payments that were received by a federal employee in a prior year. All section number references are to the Internal Revenue Code unless otherwise indicated.

Disclosure Statement

Unless specifically marked "Acknowledged Significant Advice, May Be Disseminated" above, this memorandum is not to be circulated or disseminated except as provided in Paragraphs III.D.4 and IV.A.5 of Chief Counsel Notice N (35) 000-143 (2/10/97). This document may contain confidential information subject to the attorney-client and deliberative process privileges. Therefore, this document shall not be disclosed beyond the office or individual(s) who originated the question discussed herein and are working the matter with the requisite "need to know." In no event shall it be disclosed to taxpayers or their representatives.

UILC: 61.09-00
1341.00-00
3121.01-00
3401.01-00
6051.03-00

Issues

(1) If an employee makes a repayment of salary that was received by the employee and includible in gross income in a prior year, whether the repayment of salary reduces gross income and wages in the year of repayment.

(2) Whether the repayment of salary in a year subsequent to the year of receipt creates an overcollection and overpayment of FICA

taxes for the year of receipt of the original salary payment, and whether a refund or credit of the FICA taxes may be claimed by the employer.

(3) What is the effect of a repayment of salary in one year of salary received in a prior year in reporting on Form W-2, Wage and Tax Statement, for the year in which the repayment is made and for the prior year in which the erroneous salary was originally received.

(4) If wage repayments made by an employee to an employer for erroneous wage payments made in a prior tax year are included in gross income in the year of receipt, what is the impact of § 1341 on the amount of the taxpayer's income in the year of repayment?

Conclusions

(1) Repayments of salary received in a prior year do not reduce the amount of wages paid to the employee for FICA and federal income tax withholding purposes in the year of the repayment. Thus, any remuneration for employment in the year of repayment which is used to repay the erroneous salary is not excludable from wages for FICA and federal income tax withholding purposes. Also, the repayment of salary does not reduce gross income for the prior year or affect the amount of income tax withheld in the prior year.

(2) To the extent additional FICA taxes (including social security and Medicare taxes) were paid in the prior year because of the erroneous salary payment, the repayment of the salary in a subsequent year creates an overpayment of FICA taxes in the prior year, and credit may be claimed by the employer with respect to its FICA tax liability for that prior year subject to the statute of limitations.

(3) Form W-2 for Year of Receipt of Erroneous Salary: Pursuant to section 31.6051-1(c) of the Employment Tax Regulations and subject to the statute of limitations, to the extent repayments of erroneous salary made by an employee result in a reduced amount of social security wages and/or Medicare wages for the prior year and reduced amounts of employee social security taxes and/or Medicare taxes paid for the prior year, the Employer is required to furnish corrected Forms W-2 for that prior year showing the employee's corrected "Social security wages (if applicable)," corrected "Social security tax withheld (if applicable)," corrected "Medicare wages and tips," and corrected "Medicare tax withheld." No changes should be made in the entries for "Wages, tips, other compensation" (Box 1 of Form W-2) or for "Federal income tax withheld" (Box 2 of Form W-2).

Form W-2 for Year of Repayment of Salary: The repayment of salary received in a prior year has no effect on the Form W-2 for the year of the repayment. The Employer should furnish the

employee a separate receipt acknowledging the repayment for the employee's records.

(4) If the employee received wages in year 1 under a claim of right and included the wages in gross income for year 1, and then subsequently repaid the wages to the employer in year 2 and was entitled to a deduction, then the employee may be entitled to an alternative method of calculating the amount of tax for year 2 under § 1341 of the Code. However, the employee would only be entitled to the alternative method of calculation in § 1341 if the amount of the overpayment was greater than \$3,000.

Facts

The Service Center is concerned with the correct treatment of repayments of wages by Government employees. Under the example fact pattern, an employee receives an erroneous payment of wages in one year and then repays the erroneous wages in a subsequent year. These erroneous payments occur for a variety of different reasons, including an incorrect calculation of the grade or step of the employee or an incorrect recognition of the status of the employee as a part-time employee rather than a full-time employee. The question has arisen whether the repayment in a subsequent year reduces the amount of income and wages in that subsequent year.

Law and Analysis

Issues 1 and 2

Section 61 provides that, except as otherwise provided, gross income means all income from whatever source derived.

Under section 162(a), a taxpayer may deduct all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. The performance of services as an employee is the carrying on of a trade or business.

Section 62(a) provides that the term "adjusted gross income" means, in the case of an individual, gross income minus certain listed deductions. Section 62(a)(1) provides that among those listed deductions are the deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee. Thus, except as otherwise specifically provided, the trade or business expenses of an employee are not deductible "above-the-line" in computing adjusted gross income, but are deductible as itemized deductions

in computing taxable income, subject to limitations described below.

Section 67(a) provides that, in the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income. Section 67(b) provides that, for purposes of section 67, the term "miscellaneous itemized deductions" means the itemized deductions other than certain listed deductions. Because section 162 is not among the listed itemized deductions, the itemized deduction provided under section 162 to an employee generally is a miscellaneous itemized deduction subject to the 2 percent floor of adjusted gross income. However, section 67(a)(9) provides that the term "miscellaneous itemized deduction" does include the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right).

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 Oil Consolidated v. Burnet, 286 U.S. 417 (1932). Thus, in Rev. Rul. 70-177, 1970-1 C.B. 214, the Service held that, for purposes of section 3402(a) of the Code (federal income tax withholding), the amount of an erroneous salary payment received by a federal employee was "wages" subject to income tax withholding, and, therefore, to the extent that there has been no repayment of such amount by the employee within that same year, the Form W-2 must reflect the full amount received by the employee in that year.

The federal income tax consequences of the repayment of wages previously received under a claim of right depends upon the year of repayment. If repayment is made in the same calendar year that the wages were received under a claim of right, the amount is excluded from gross income. The repayment results in a reduction in gross income and wages rather than a deduction. See Couch v. Commissioner, 1 B.T.A. 103 (1924), acq., IV-1 C.B. 1 (1925). (However, for the amount repaid to be excludable from income, it must not be a repayment of an independent collateral obligation. See Butchko v. Commissioner, 638 F.2d 1214 (9th Cir. 1981).) However, if a repayment is made in a calendar year subsequent to receipt of the amount, the amount is included in gross income in the year that it is received under the claim of right doctrine and the taxpayer may be entitled to a deduction for the amount of the repayment in the year the repayment is made. There is no exclusion from gross income in the year of repayment for salary amounts otherwise payable that are used to make the salary repayments. See Rev. Rul. 67-48, 1967-1 C.B. 50; Healy v. Commissioner, 345 U.S. 278 (1953); and Oswald v. Commissioner, 49 T.C. 645 (1968), acq., 1968-2 C.B. 1.

As you are aware, the FICA tax is composed of two different taxes: (1) the OASDI tax, which is referred to as social security tax on Service reporting forms (for example, Form W-2) and (2) the hospital insurance tax, which is referred to as Medicare tax. The OASDI tax is imposed by sections 3101(a) and 3111(a) of the Internal Revenue Code (Code). The Medicare tax is imposed by sections 3101(b) and 3111(b).

FICA taxes are imposed on wages, which is defined in section 3121(a) as including all remuneration for employment unless specifically excepted. The services of virtually all federal employees are subject to Medicare taxes under section 3121(u)(1). Also, generally, the services of federal workers are subject to OASDI tax (social security tax) unless the worker (1) is performing services in a position that would have been excluded from FICA tax if the law in January 1983 had remained in effect, and (2) (a) has continuously been performing services that would have been excluded under old law for the federal government since December 31, 1983, or (b) is receiving an annuity under a federal employee retirement system.

Services in the employ of the United States Government are not subject to the taxes imposed under the Federal Unemployment Tax Act (FUTA). See section 3306(c)(6).

Rev. Rul. 79-311, 1979-2 C.B. 25, concerned a situation in which an employee tendered payment for unearned advances from a prior year that he was legally obligated to repay. In Rev. Rul. 79-311, two individuals (A and B) employed by a company beginning in 1975 received semimonthly payments for commissions earned or to be earned, from which federal employment taxes were properly withheld. The gross amount advanced to each employee as commissions earned or to be earned aggregated \$9,600 in 1975. An additional \$800 was advanced to B during 1976. However, each employee earned only \$8,640 of commissions during 1975, and B earned only \$720 of commissions in 1976. A resigned on December 31, 1975, and B resigned on February 5, 1976. Pursuant to express provisions of the contract of employment of each employee, each repaid the company at the time of resignation the excess amount advanced to each.

Rev. Rul. 79-311 held that, generally, the advances were income to the employees at the time of receipt. With respect to the advances that were repaid in the same year they were received, such advances were held to be excludable from the gross income of the employee. See Couch, cited above. With respect to the excess advances that were repaid by B in the year subsequent to the year received, the ruling holds that B may not exclude from B's gross income the amount of such repayments. The ruling concludes that B is entitled to a deduction in the year of repayment of that portion of the repayment used to restore

advances received in prior years. The ruling concludes that the repayment is deductible from B's adjusted gross income in computing taxable income and is allowable only if B itemizes deductions.

Section 6401(c) of the Code provides that an amount paid as tax shall not be considered not to constitute an overpayment solely by reason of the fact that there was no tax liability in respect of which such amount was paid.

Section 6413(a) of the Code provides that if more than the correct amount of FICA tax imposed by section 3101 is paid with respect to any payment of remuneration, proper adjustment shall be made, in such manner and at such time as the Secretary or his delegate may prescribe by regulations. Section 6413(b) provides that if an overpayment cannot be adjusted under section 6413(a), the amount of the overpayment shall be refunded in such manner and at such time as the Secretary or his delegate may prescribe by regulations.

Section 31.6413(a)-1(b)(1) of the Employment Tax Regulations concerns repayments by employers of FICA taxes erroneously collected from employees, if the repayment is made after the employer has filed its return for the period in which the tax was erroneously collected. The regulation provides that if an employer collects from an employee and pays more than the correct amount of tax under section 3101, and if the error is ascertained within the applicable period of limitation on credit or refund, the employer shall repay or reimburse the employee in the amount thereof prior to the expiration of the return period following the return period in which the error is ascertained and prior to the expiration of such limitation period. The regulation further provides that if such repayment by the employer occurs, the employer shall obtain and keep as part of his records a written receipt of the employee showing the date and the amount of the repayment. In addition, if an employer repays or reimburses an employee in any calendar year an overpayment of tax collected under section 3101, section 31.6413(a)-1(b)(1) of the regulations provides that the employer shall obtain and keep as part of his records a written statement that the employee has not and will not claim any refund or credit for such overpayment (or if the employee has filed a claim, that such claim has been rejected). The employer may obtain credit for such payment pursuant to section 31.6413(a)-2(a)(1) of the regulations.

Section 31.6413(a)-2(a)(1) of the regulations provides that after an employer repays or reimburses an employee in the amount of an overcollection, as provided in section 31.6413(a)-1(b)(1), the employer may claim credit for such amount in the manner, and subject to the conditions, stated in section 31.6402(a)-2. Such credit shall constitute an adjustment without interest, if the

amount thereof is entered on a return for a period ending on or before the last day for the return period following the return period in which the error was ascertained. No credit or adjustment in respect of an overpayment shall be entered on a return after the filing of a claim for refund of such payment.

Section 31.6413(a)-2(a)(2) of the regulations provides that if an employer pays more than the correct amount of employer tax under section 3111, the employer may claim credit for the amount of the overpayment in the manner, and subject to the conditions, stated in section 31.6402(a)-2. Such credit shall constitute an adjustment, without interest, if the amount thereof is entered on the same return on which the employer adjusts, pursuant to section 31.6413(a)-2(a)(1), a corresponding overpayment of employee tax.

The effect of the above regulations on repayments of salary is illustrated in Rev. Rul. 79-311. Under the facts of the ruling, B received excess commissions in 1975 that he was required to repay in 1976. FICA taxes had been withheld from the excess commissions paid in 1975. The ruling holds that B should be given credit for the FICA employee taxes deducted in 1975 pursuant to section 6413(a) of the Code and section 31.6413(a)-1(b)(1) of the regulations. The adjustment with respect to the excess commissions paid to B in 1975 was reported on the next Form 941 filed by the company, the Form 941 for the first quarter of 1976. Also, at the time the adjustment was reported on Form 941, the employer furnished B with a 1975 Form W-2 marked "Corrected by Employer" showing B's corrected FICA employee tax pursuant to section 31.6051-1(c) of the regulations. The Company also obtained credit or refund of the employer's FICA tax attributable to the excess commissions repaid by B pursuant to section 6413 of the Code and the regulations.

However, the repayments of salary in a year subsequent to the year of receipt do not reduce the amount of wages for federal employment tax purposes of the employee for the year in which the repayment is made. The repayment relates to amounts that were received in a prior calendar year, and employees may take account of repayments of wages received in a prior year for federal income tax purposes only by taking the repayment as an itemized deduction (subject to the 2 percent floor under section 67, except as provided in section 67(b)(9)). See Rev. Rul. 79-311.

The FICA tax consequences of the repayment of an erroneous salary payment which was previously included in FICA wages are as follows provided the applicable statute of limitations is met and to the extent additional FICA taxes were paid because of inclusion of the erroneous salary payment in wages (i.e., the employee's other remuneration for employment paid by the employer during the prior year did not equal or exceed the maximum wage

base for the prior year). The repayment of the erroneous salary payment by the employee creates an overcollection and overpayment of FICA taxes for that prior year. Actual repayment of wages by the employee to the employer (through payroll deduction or otherwise) must occur before an overpayment exists. The mere fact that it is established that an employee received an erroneous wage payment in a prior year (and is liable to the employer for such repayment) does not create an overpayment of FICA taxes in the prior year. If the employee does not repay the erroneous salary payment, the employee is still in actual receipt of the wages in question, and thus, such amounts remain wages and no overpayment exists.

After the employer repays or reimburses an employee in the amount of an overcollection of employee FICA taxes, as provided in section 31.6413(a)-1(b)(1) of the regulations, the employer may claim credit for such amount in the manner and subject to the conditions stated in section 31.6402(a)-2. Such credit shall constitute an adjustment, without interest, if the amount is entered on the Form 941 for the period in which the error was ascertained or on the Form 941 for the return period following the return period in which the error was ascertained. For this purpose, the error is ascertained when a repayment of the erroneous salary amounts is made by an employee.

The employer may claim credit for an overpayment of employer FICA tax with respect to an erroneous salary payment that is repaid by the employee in the manner and subject to the conditions, stated in section 31.6413(a)-2 of the regulations. Such credit shall constitute an adjustment, without interest, if the amount thereof is entered on the same return on which the employer adjusts a corresponding overpayment of employee tax.

Issue 3

Section 31.6051-1(b)(1) provides that if (i) the amount of employee tax under section 3101 deducted and withheld in the calendar year from the wages, as defined in section 3121(a), paid during such year was less or greater than the tax imposed by section 3101 on such wages by reason of the adjustment in such year of an overcollection of the tax in any prior year, or (ii) regardless of the reason for the error or the method of its correction, the amount of wages as defined in section 3121(a), or tax under section 3101, entered on a statement furnished pursuant to this section to an employee for a prior year was incorrect, a corrected statement for such prior year reflecting the adjustment or the correct data shall be furnished to the employee. Such statement shall be marked "Corrected by Employer."

Issue 4

Generally, for a cash basis taxpayer, a deduction is taken into account in the year in which the expenses are paid. See § 461. This approach was dictated by Congress' adoption of an annual accounting system as an integral part of the tax code. See Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).

Section 1341 of the Code provides for an alternative method to compute tax where, in a subsequent year, a taxpayer restores a substantial amount included in a previous year's income under a claim of right. See North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). Section 1341 of the Code was enacted to alleviate some of the discrepancies between the tax benefit of the deduction in the year of repayment versus the increase in taxes attributable to the receipt of the income in the prior year (due to tax rate or bracket changes). See U.S. v. Skelly Oil Co., 394 U.S. 678 (1969).

Section 1341 provides that when a substantial amount (more than \$3,000) held under a claim of right is restored by the taxpayer, the taxpayer has two alternative methods of calculating the tax liability for the year of repayment. In order to utilize the alternative method in § 1341, however, a taxpayer must meet the following requirements:

- (1) taxpayer must have included the item in gross income in a prior tax year (or years) because it appeared that the taxpayer had an unrestricted right to the item;
- (2) the taxpayer must be entitled to a deduction for the year of repayment because it was established after the close of the prior tax year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of the item; and
- (3) the amount of the deduction must exceed \$3,000.

If the taxpayer meets all of the above requirements, then there are two alternative methods to use in calculating the tax liability for the year of repayment. The tax liability for the year of repayment is the lesser of the following:

- (1) the tax for the year of repayment computed with a deduction for the amount restored under a claim of right; or
- (2) an amount equal to:
 - (A) the tax for the year of repayment computed without the deduction, minus,
 - (B) the decrease in tax for the prior taxable year (or years) which would result solely from the exclusion of the

item (or portion thereof) from gross income for the prior taxable year (or years).

Accordingly, if, as a result of repaying wages included in income in a prior year, (1) the taxpayer is entitled to a deduction, (2) the wages were received under a claim of right, and (3) the deduction is for more than \$3,000, then the taxpayer will be entitled to account for the repayment under the alternative method provided in § 1341.

If you have any questions concerning this issue, please call (202) 622-6040.

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