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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Back Wage Payment

This Field Service Advice responds to your communication dated November 3, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Entity =

Employee =

x =

State =

Year 1 =

Year 2 =

ISSUES

(1) Whether a payment in settlement of a claim for back pay by a federal employee is subject to the employee's election to participate in the Federal Thrift Plan, and requires employer matching contributions.

(2) Whether a payment in settlement of a claim for back pay arising from the employee's allegation that he was not adequately compensated for his job duties is

includible in gross income.

(3) Whether the payment is subject to federal income tax withholding and what is the appropriate amount of federal income tax withholding.

(4) What is the appropriate amount of State income tax withholding with respect to the settlement payment.

(5) Whether the payment is subject to the taxes imposed under I.R.C. sections 3101(a) and 3111(a) (the Old-Age, Survivors, and Disability Insurance (OASDI) taxes, or social security taxes, portion of the Federal Insurance Contributions Act (FICA)) and how is the amount of the liability for OASDI tax calculated.

(6) Whether the payment is subject to the taxes imposed under I.R.C. sections 3101(b) and 3111(b) (the hospital insurance taxes, or Medicare taxes, portion of the FICA) and how is the amount of the Medicare tax calculated.

(7) If an employer erroneously fails to withhold federal income taxes from a wage payment, whether the employer is liable for the amount of the federal income tax withholding.

(8) If an employer erroneously fails to withhold the employee portion of the FICA (social security and Medicare) taxes from the wages of an employee, whether the employer is liable for the amount of the employee FICA taxes.

(9) If an employer erroneously fails to withhold State A income tax from the wages of an employee, whether the employer is liable for the amount of the State A income tax withholding.

(10) If an employer erroneously fails to make Federal Thrift Plan contributions from a payment of wages, whether the employer is liable for the payment of these contributions.

(11) If an employer who has erroneously failed to withhold federal income tax from a wage payment in Year 1 is liable for payment of federal income tax withholding, whether the payment of the federal income tax withholding liability for Year 1 in Year 2 results in additional income and wages to the employee.

(12) If an employer who has erroneously failed to withhold the employee portion of FICA taxes from a wages is liable for payment of the FICA employee taxes, whether the employer's payment of the employee portion of FICA tax without deduction from the remuneration of the employee results in additional income and wages to the employee.

(13) If an employer who has erroneously failed to make contributions to the Federal Thrift Plan from a payment to the employee, whether a subsequent payment by the employer to make those contributions is income and wages to the employee.

CONCLUSIONS

(1) These issues are under the jurisdiction of the Federal Retirement Thrift Investment Board, 1250 H Street, N.W., Washington, DC 20005.

(2) The entire amount of the payment (x dollars) is includible in gross income.

(3) The entire amount of the payment (x dollars) is wages subject to federal income tax withholding. The appropriate amount of income tax withholding on this supplemental wage payment is, at the option of the employer, either 28 percent of x dollars, or the amount derived by using the first method described in section 31.3402(g)-1(a)(2), which is based on aggregating the supplemental wage payment with the employee's last preceding payment of regular wages.

(4) This issue of whether State A withholding applies is not under our jurisdiction and is a question for the tax authorities of State A.

(5) The entire amount of the payment (x dollars) is subject to social security taxes. The liability for the employee portion of the social security tax is equal to .062 multiplied by x dollars. The liability for the employer portion of the tax is equal to .062 multiplied by x dollars.

(6) The entire amount of the payment (x dollars) is subject to Medicare taxes. The liability for the employee portion of the Medicare tax is equal to .0145 multiplied by x dollars. The liability for the employer portion of the tax is equal to .0145 multiplied by x dollars.

(7) If an employer erroneously fails to withhold federal income taxes from the wages of an employee, the employer is liable for the amount of withholding required to be paid, unless the employer can show that the employee included the amount of wages on the employee's return and paid income taxes thereon.

(8) If an employer erroneously fails to withhold FICA taxes from the wages of an employee, the employer is liable for the employee portion of the FICA tax (in addition to the employer portion of the FICA tax). The employee is also liable for the employee portion of the FICA tax. In the event the employer should pay this back liability for the employee portion of FICA taxes, the employee is obligated to the employer for this employee portion of the FICA, and the employer can recover the amount of the employee FICA tax by deducting the employee tax from other

remuneration of the employee under the control of the employer, even if the remuneration does not constitute wages. If such a deduction from the employee's remuneration to pay the employee portion of the FICA tax on the wage is not made, the obligation of the employee to the employer with respect to the undercollection of the employee portion of the FICA is a matter for settlement between the employer and the employee.

(9) The issue of whether an employer is liable for State A income tax withholding is under the jurisdiction of the State A tax authorities.

(10) The issue of liability for Federal Thrift Plan contributions is under the jurisdiction of the Federal Retirement Thrift Investment Board.

(11) The payment in Year 2 of the employer's liability for federal income tax withholding for wages paid in Year 1 from which income tax was not withheld does not result in additional income or wages to the employee for Year 1 or Year 2. The employee's liability for federal income tax for Year 1 with respect to the settlement payment received in Year 1 is unaffected by the employer's payment in Year 2 of its federal income tax withholding liability related to the Year 1 payment. The employee remains liable for the income tax liability resulting from the inclusion of the wage payment in the Year 1 gross income of the employee.

(12) The employer's payment in Year 2, without deduction from the remuneration of the employee, of the employee portion of the FICA tax imposed with respect to the wage payment in Year 1 results in additional gross income and wages (for FICA taxes and federal income tax withholding purposes) to the employee in the year of the payment of the tax by the employer (i.e., Year 2). The employee is obligated to repay the employee portion of the FICA tax relating to Year 1 to the employer. To the extent the employee reimburses the employer during the calendar year (Year 2) for the payment of the employee portion of the FICA taxes relating to Year 1, the employee's gross income for Year 2 resulting from the employer's payment of the tax is reduced. To the extent the employee repays the employee portion of the FICA taxes relating to Year 1 in Year 2 or any subsequent year (subject to the period of limitations), the FICA wages for Year 2 are reduced.

(13) The contributions by the employer to the Federal Thrift Plan would be employer contributions to the Thrift Plan, would not be includible in the gross income of the employee, and would not be wages for income tax withholding purposes. The question of liability for FICA tax with respect to the contributions would depend on the treatment of the payments by the Federal Retirement Thrift Investment Board.

FACTS

The Employee was employed by the Entity, an agency of the United States Government until 1998. The Employee filed a grievance against the Entity, alleging the work he was performing was improperly classified for pay purposes under the General Schedule. He sought back pay and punitive damages because he alleged that he was paid at an inappropriate lower grade for higher grade duties.

The grievance was settled. The settlement agreement provides that "in full, complete, and binding settlement" of the grievance, the Entity "agrees to pay the Grievant a lump sum of [x dollars]." The agreement states that "[e]xcept as outlined above, the parties agree to bear their own costs." The agreement also provides that "[t]his agreement does not constitute an admission of any wrongdoing or violation of any law, rule, or regulation by the ...[Entity] or its agents or employees." The settlement documents did not characterize the settlement payment. No withholding was made from the lump sum payment of x dollars and therefore, the Employee received a check for x dollars. The employee also received a Form W-2, Wage and Tax Statement, which included x dollars in Box 1 as "Wages, tips, other compensation." The amount was not included in another box on the Form W-2. The employee also received an additional Form W-2 for Year 1 related to other wages received in Year 1 for services performed for the Entity.

According to the material submitted, it is a well-established principle that punitive damages are not available for grievances against the Government. You state that the Employee would not have received punitive damages even if he had fully prevailed at arbitration. It is our understanding that the employee was covered under the Federal Employees' Retirement System (FERS) in his performance of services for the Government.

LAW AND ANALYSIS

The Conclusions on Issues (1), (4), (9), and (10) are self-explanatory; therefore, there is no discussion related to those issues.

Issue (2)

Section 61 provides that gross income includes "all income from whatever source derived" except as otherwise provided in this subtitle. There has been no argument that any part of the x dollars qualifies for an exclusion from gross income. The settlement agreement provided that the lump sum payment of x dollars was in "full, complete, and binding settlement" of the Employee's grievance. Therefore, the settlement payment of x dollars is includible in the gross income of the Employee.

Issue (3)

Section 3402(a) 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 of the Treasury. The term "wages" is defined in section 3401(a) as all remuneration for services performed by an employee for his employer.

Section 31.3401(a)-1(a)(5) of the regulations provides that remuneration for services, unless such remuneration is 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. Section 31.3401(a)-1(a)(3) provides that the basis upon which the remuneration is paid is immaterial in determining whether the remuneration constitutes wages.

The determination of whether FICA taxes and federal income tax withholding apply to payments in settlement of an employee's claim against an employer is made by reference to the nature of the claim made by the employee. The fact that an employer, for the purpose of avoiding litigation or other expense, settles a claim by paying an amount that is less than what was claimed by the employee, is of little relevance in determining whether the settlement payment is wages. The characterization of the payments by the employer and the employee is not necessarily controlling. Mayberry v. United States, 151 F.3d 855, 859 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204, 209-211 (4th Cir. 1997).

In the instant case, the Employee's grievance alleged that he was inadequately compensated for his services for the Entity. Because the Employee sought to recover compensation for services performed at a higher grade level, the settlement payment is wages for federal income tax withholding purposes. See Rev. Rul. 96-65, 1996-2 C.B. 6.

Section 31.3402(g)-1(a)(1) of the Employment Tax Regulations provides that an employee's remuneration may consist of wages paid for a payroll period and supplemental wages, such as bonuses, commissions, and overtime pay, paid for the same or a different period, or without regard to a particular period. When such supplemental wages are paid (whether or not at the same time as the regular wages), the amount of the tax required to be withheld under section 3402(a) (the percentage method) or under section 3402(c) (the wage bracket method) shall be determined in accordance with this paragraph (a) of this regulation section or paragraph (b) of this section.

Section 31.3402(g)-1(a)(2) of the regulations provides that the supplemental wages, if paid concurrently with wages for a payroll period, shall be aggregated

with the wages paid for such payroll period. If not paid concurrently, the supplemental wages shall be aggregated with the wages paid or to be paid within the same calendar year for the last preceding payroll period or for the current payroll period. The amount of tax to be withheld shall be determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period.

If, however, supplemental wages are paid and tax has been withheld from the employee's regular wages, the employer may determine the tax to be withheld by using a flat percentage rate of 28 percent without allowance for exemption and without reference to any regular payment of wages. See section 31.3401(g)-1(a)(2) of the regulations and section 13273 of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.

The settlement payment is a supplemental wage payment, which is paid in addition to the regular wages that were received by the Employee during Year 1. The supplemental wages were paid separately from the regular wages. Income taxes were withheld from the regular wages paid to the Employee during Year 1 for his services for the Entity. Therefore, the correct amount of withholding can be determined under either of the following methods, at the option of the employer:

> (a) Withhold a flat 28 percent rate of the amount of the settlement payment (i.e., the amount of income tax withholding is equal to .28 multiplied by x); or
>
> (b) Add the supplemental wages and the last preceding payment of regular wages in Year 1. Then compute the income tax withholding as if the total of those regular wages and the supplemental wages were a single payment for a regular payroll period. Subtract the tax already withheld from the regular wage payment. Withhold the remaining tax from the supplemental wages.

Issues (5)-(6)

FICA taxes are composed of the OASDI taxes imposed under sections 3101(a) and 3111(a), also known as social security taxes, and the hospital insurance tax imposed by sections 3101(b) and 3111(b), also known as Medicare taxes. Because the Employee was covered under the FERS in his employment with the Entity, the remuneration he received for his services was wages for OASDI and Medicare tax purposes. His services did not qualify for the exception from employment provided for certain federal employment by either section 3121(b)(5) or 3121(b)(6). Thus, the employee's services for the Entity were included within employment for OASDI and Medicare tax purposes. The question is whether the settlement payment is remuneration for that employment and thus wages under section 3121(a).

FICA taxes are imposed on "wages." Section 3121(a) defines wages as "all remuneration for employment" unless specifically excepted. Courts have stressed that "wages" is broadly defined to include not only remuneration for work actually done but also remuneration for the "entire employer-employee relationship for which compensation is paid to the employee by the employer." Social Security Board v. Nierotko, 327 U.S. 358 (1946). See also Hemelt, 122 F.3d at 209-211. Thus, in Nierotko, the Supreme Court held that back pay paid by an employer under the National Labor Relations Act to an illegally terminated employee for a period during which the individual performed no services for the employer was wages for social security benefit purposes. The Nierotko case has been applied in determining the FICA taxation of settlements of back pay claims by employees generally under a variety of employee rights statutes. Rev. Rul. 96-65, 1996-2 C.B. 6; Mayberry, 151 F.3d at 860; Hemelt, 122 F.3d at 209-211; Gerbec v. United States, 164 F.3d 1015 (6th Cir. 1999). Thus, generally, payments in settlement of claims by employees for back pay as a result of alleged violations by employers of statutes conferring employee rights are wages for FICA tax purposes.

A payment received by an employee in settlement of a claim that the employee did not receive adequate remuneration for the services that he or she performed for an employer because his job was classified at a lower pay grade than appropriate would fit within the definition of FICA wages under the above authority. Settlement payments related to this type of case are particularly strong cases because the employee actually performed the services and is alleging that he was inadequately compensated for such services. The settlement payment, which arises from the services that he performed for the Entity, is treated for FICA tax purposes in the same manner as other remuneration for employment that he received for services performed for the Entity. Thus, the settlement payment under the given facts meets the definition of wages for FICA tax purposes, and is wages for purposes of the OASDI tax and the Medicare tax.

Under section 3101(a), the amount of the employee portion of the OASDI tax is equal to 6.2 percent of the wages received. Section 3111(a) provides that the employer portion of the OASDI tax is also 6.2 percent of the wages received. The amount of wages for OASDI purposes in a calendar year is subject to a maximum wage base equal to the contribution and benefit base for that year as determined under section 230 of the Social Security Act. In this case the amount of the employee portion of OASDI tax is equal to (.062)x.

Under section 3101(b), the amount of the employee portion of the Medicare tax is equal to 1.45 percent of the wages received. Section 3111(b) provides that the employer portion of the Medicare tax is also 1.45 percent of the wages received. There is no maximum wage base for Medicare tax purposes. The amount of the employee portion of Medicare tax is equal to (.0145)x.

Issue (7)

Section 3403 provides that the employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter [i.e., I.R.C. chapter 24, Collection of Income Tax at Source on Wages], and shall not be liable to any person for the amount of any such payment.

Section 31.3403-1 of the regulations provides that every employer required to deduct and withhold the tax under section 3402 from the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee by the employer. If, for example, the employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax. See, however, section 31.3402(d)-1 of the regulations.

Section 3402(d) provides that, if the employer, in violation of the provisions of chapter 24, fails to deduct and withhold the tax under this chapter and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer. However, section 3402(d) further provides that section 3402(d) shall in no case relieve the employer from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

Section 31.3402(d)-1 of the regulations provides that if the employer in violation of the provisions of section 3402 fails to deduct and withhold the tax, and thereafter, the income tax against which the tax under section 3402 may be credited is paid, the tax under section 3402 shall not be collected from the employer. The employer will not be relieved of his liability for payment of the tax required to be withheld unless he can show that the tax against which the tax under section 3402 may be credited has been paid.

Section 6205 relates to adjustments of an employer's liability for FICA taxes and income tax withholding in situations in which the employer has made an undercollection or underpayment of FICA taxes or income tax withholding. Section 31.6205-1(c)(4) of the Employment Tax Regulations provides that if no income tax, or less than the correct amount of income tax, required under section 3402 to be withheld from wages is deducted from wages paid to an employee in a calendar year, the employer shall collect the amount of the undercollection on or before the last day of such year by deducting such amount from remuneration of the employee, if any, under the control of the employer. Such deductions may be made even though the remuneration, for any reason, does not constitute wages. Any undercollection in a calendar year not corrected by a deduction made pursuant to the foregoing provisions of this subparagraph is a matter for settlement between the

employee and the employer within such calendar year. There is a special exception to this general rule; the exception is related to taxable noncash fringe benefits and has no application in the instant case. See Announcement 85-113 and Publication 15-A, Employer's Supplemental Tax Guide, pages 13-14.

If an employer erroneously fails to withhold federal income taxes from a payment of wages to an employee, the employer can correct that mistake during the same calendar year of the payment by deducting the amount of the undercollection from other remuneration of the employee under the control of the employer. If the amount of the undercollection of income tax withholding is not collected by the employer from remuneration of the employee or in some other manner before the end of the calendar year, then in subsequent years the employer is liable to the Government for amount of income tax withholding unless section 3402(d) applies.

Issue (8)

Section 3102(b) provides that every employer required to deduct the employee portion of the FICA tax shall be liable for the payment of such tax, and shall be indemnified against the claims and demands of any person for the amount of any such payment made by such employer.

Section 31.3102-1(c) of the regulations provides that the employer is liable for the employee tax with respect to all wages paid by the employer to each of its employees regardless of whether or not it is collected from the employee. If, for example, the employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax. Until collected from the employee, the employee is also liable for the employee tax with respect to all the wages received by the employee.

Section 6205 relates to adjustments of undercollections and underpayments of FICA tax by employers. Section 31.6205-1(b)(3) provides that if an employer collects no FICA employee tax or less than the correct amount of FICA employee tax from an employee with respect to a payment of wages as defined in the FICA, the employer shall collect the amount of the undercollection by deducting such amount from remuneration of the employee, if any, under the employer's control after the employer ascertains the error. Such deductions may be made even though the remuneration, for any reason, does not constitute wages or compensation. The amount of an undercollection of employee tax from an employee shall be reported and paid by the employer, whether or not the undercollection is corrected by a deduction from the remuneration of the employee. If such a deduction is not made, the obligation of the employee to the employer with respect to the undercollection is a matter for settlement between the employee and the employer.

The employee is also liable for the unpaid employee portion of the FICA tax under section 31.3102-1(c). See Navarro v. United States, 72 A.F.T.R.2d (RIA) 5424 (W.D. Tex. 1993), which held that both the employer and the employee are liable to for the employee portion of the FICA tax and that the Internal Revenue Service is not required to seek payment first from the employer in collecting unpaid employee FICA tax. If the employer pays the employee portion pursuant to the section 6205 regulations, the employee would then be obligated to the employer for the amount of the employee FICA tax, under section 31.6205-1(b)(3) of the regulations.[1]

Issue (11)

Generally, if an employer makes a payment in year 2 (or a subsequent year) of income tax withholding liability incurred with respect to a wage payment to an employee in Year 1 from which income tax was erroneously not withheld, there is no effect on the gross income or income tax liability of the employee.[2] The employer is satisfying the liability of the employer under section 3402 for the income tax withholding, and the employee cannot get credit under section 31 with respect to his or her income tax liability under section 1 for such amounts paid by the employer that were never withheld from the employee's wages. The employer in making the payment in Year 2 is not satisfying the income tax liability of the employee with respect to income tax in Year 1, and is not making a payment which may be credited or refunded to the employee. The distinction between income tax withholding made by the employer in the calendar year of the payment of wages and the payments of income tax withholding by the employer in subsequent years is reflected in the section 6205 regulations cited above, which provide that the employer can recover from the employee only income tax withholding during the calendar year of the payment, and cannot recover from the employee the income tax withholding after the end of the calendar year. Because the employer payment of income tax withholding in this situation does not relieve the liability of the employee for income tax with respect to the back wages, the employee's gross incomes for Year 1 and Year 2 remain unaffected.

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[1] Although not raised as an issue in this case, the obligation of the employee to the employer with respect to employee FICA tax is based on the presumption that the employee is liable for the employee tax at the time of the employer's payment of the employee portion of the tax (i.e., the period of limitations for purposes of the employee's liability for the FICA employee tax has not run).

[2] As noted above, a special rule exists for purposes of certain taxable noncash fringe benefits.

Section 31(a)(1) provides that the amount withheld as tax under chapter 24 shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle. Section 31(a)(2) provides that the amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

Section 1.31-1(a) of the Income Tax Regulations provides that if the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer.

It has long been settled that an employee is entitled to a credit under section 31 only for amounts that his or her employer actually withheld from the employee's wages. See Edwards v. Commissioner, 323 F.2d 751, 752 (9th Cir. 1963); Chrisman v. Commissioner, T.C.Memo. 1990-305; In re Eryurt, 142 B.R. 979, 1000-1001 (M.D. Fla. 1992); Harper v. Commissioner, T.C.Memo. 1990-239; Church v. Commissioner, 810 F.2d 19, 20 (2d Cir. 1987). The question whether income tax was actually withheld from a payment is separate from the question of whether the payment should have been treated as wages.

The instant factual situation, in which an employer makes a payment to the Government for income tax withholding liability relating to a prior year should be distinguished from two very different factual situations: (a) a situation where, at the time of the wage payment in Year 1, the employer has agreed to pay the amount of the income tax withholding with respect to a net amount received by the employee; and (b) a situation where the employer makes a payment directly to the employee in Year 2 so that the employee can pay the employee's income tax liability with respect to the wage payment in Year 1.

In situation (a) in the previous paragraph, where the employer has agreed to pay the income tax withholding with respect to a net wage payment and pays a net amount to the employee, the net amount is grossed up to determine the amount of wages for income tax withholding purposes so that when the amount of income tax withholding is subtracted from the wages, the employee is left with the net amount. See, e.g., Rul. 58-113, 1958-1 C.B. 362; Rev. Rul. 86-14, 1986-1 C.B. 304. However, situation (a) is not the situation in the instant case. There is no evidence to support the existence of an agreement by the Entity to pay the withholding tax of the Employee. The settlement payment was erroneously treated as a payment of "other compensation" and not wages to the employee.

In situation (b), the cash payment by the employer to the employee in year 2 would not be a payment of the income tax withholding liability of the employer but would

simply be a cash payment to the employee for the employee to satisfy an obligation of the employee. Under this situation (b), the cash payment by the employer to the employee would be includible in the employee's gross income. The payment would also be wages for federal income tax withholding purposes (and for purposes of other applicable employment taxes) in Year 2. If the employee subsequently does pay the income tax with respect to the wages, the employer is relieved of liability for any income tax withholding in Year 1 under section 3402(d).

Because neither situation (a) nor (b) applies, the basic rule related to employer payments of income tax withholding liability after the year of the wage payment in which income taxes were not withheld applies. Thus, the employer's payment in Year 2 of the income tax withholding liability related to the settlement payment would not result in income and wages to the employee.

Issue (12)

Section 61 provides that gross income means all income from whatever source derived, including compensation for services, fees, commissions, fringe benefits, and similar items. Taxes assessed against an employee and paid by an employer in partial consideration for services are includible in the employee's gross income. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929), VIII-2 C.B. 22 (1929).

Section 3121(a)(6)(A) excepts from "wages" for FICA purposes an employer's payment (without deduction from the employee's pay) of the employee FICA taxes imposed by section 3101, in the case of pay for domestic service in the employer's private home or for agricultural labor. Section 3121(a)(6)(A) previously excepted from wages all payments of employee FICA taxes by an employer without deduction from the employee's pay, but the exception was limited to domestic service in the employer's home and agricultural labor by section 1141 of the Omnibus Reconciliation Act of 1980, 1980-2 C.B. 509, 530, effective generally for remuneration paid after December 31, 1980. The effect of section 1141 of the 1980 Act is that if an employer pays the employee FICA taxes imposed by section 3101 without deducting them from the employee's pay, the amount of the employee's wages is increased by the amount of the taxes. See Rev. Rul. 86-14, 1986-1 C.B. 304.

Section 31.3401(a)-1(b)(6) of the regulations states that the term "wages' for income tax withholding purposes includes amounts paid by an employer on behalf of an employee (without deduction from the remuneration of, or other reimbursement from, the employee) on account of any tax imposed on the employee, including the tax imposed by section 3101 (the employee portion of FICA taxes).

In a situation in which the employer is correcting a failure to deduct and pay the employee portion of the FICA tax, the employer's payment of the employee's liability with respect to the employee portion of the FICA taxes without deduction from the remuneration of the employee or without reimbursement by the employee results in additional gross income and wages to the employee.[3] The employee remains liable to the employer for the employee portion of the FICA taxes under section 31.6205-1(b)(3) of the regulations. The employer's payment of the employee's liability for the employee portion of the employee tax is remuneration for employment, and no exception from the definition of wages under the FICA applies. See Rev. Rul. 86-14, 1986-1 C.B. 304; Rev. Proc. 81-48, 1981-2 C.B. 623.

Treatment of the employer's payment of the employee portion of the FICA taxes as includible in the gross income of the employee and wages to the employee is premised on the employee's personal liability for the employee taxes at the time the employer makes the adjustment to its FICA tax return. If the period of limitations applicable to the employee's liability for employee FICA tax has expired at the time of the employer's adjustment of its FICA tax liability, the employer's payment of the FICA employee tax would not result in income and wages to the employee, because the employer is not satisfying a liability of the employee.[4]

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[3] This result does not apply in the case of a determination of an employer's liability with respect to employee FICA tax under section 3509. Section 3509 generally applies if any employer fails to deduct and withhold income tax or FICA employee tax with respect to any employee by reason of treating such employee as not being an employee and the failure to withhold is not because of intentional disregard for withholding requirements. Section 3509(d)(1) provides that if the amount of any liability is determined under section 3509 – (A) the employee's liability for tax shall not be affected by the assessment or collection of the tax so determined, (B) the employer shall not be entitled to recover from the employee any tax so determined, and (C) section 3402(d) and section 6521 shall not apply.

[4] Section 6501(a) provides that the amount of any tax imposed by the Code must be assessed within 3 years after the return was filed. A return reporting FICA or income tax withholding for any period ending with or within a calendar year that is filed before April 15 of the following year is considered to be filed on April 15 of the following year. Section 6501(b)(2). The statute date for the period of limitations on the employee's share of FICA taxes is determined by the statute date of the Form 941 filed by the employer. To extend the statute on the employer's liability for the employee's share of FICA taxes, a Form SS-10, Consent to Extend the Time to Assess Employment Taxes) must be secured from the employer. To extend the statute on the employee's liability for the employee's share of FICA tax, a Form SS-10 must be secured from the employee. An extension of the period of limitations by the employer

To the extent the employee reimburses the employer during the calendar year (Year 2) for the payment of the employee portion of the FICA taxes relating to Year 1, the employee's gross income for Year 2 resulting from the employer's payment of the tax is reduced. To the extent the employee repays the employee portion of the FICA taxes relating to Year 1 in Year 2 or any subsequent year (subject to the period of limitations), the FICA wages for Year 2 are reduced. See, for example, Rev. Rul. 79-311, 1979-2 C.B. 25.

Issue (13)

Section 7701(j)(1)(A) provides that the Thrift Savings Fund shall be treated as a trust described in section 401(a) which is exempt from taxation under section 501(a). Section 7701(j)(1)(B) provides that any contribution to, or distribution from, the Thrift Savings Fund shall be treated in the same manner as contributions to or distributions from such a trust. Section 7701(j)(1)(C) provides that generally, subject to certain limitations, contributions to the Thrift Savings Fund shall not be treated as distributed or made available to an employee or member nor as a contribution made to the Fund by an employee or Member merely because the employee or Member has an election whether the contributions will be made to the Thrift Savings Fund or received by the employee or Member in cash.

Section 7701(j)(3) provides that section 7701(j)(1) shall not be construed to provide that any amount of the employee's or Member's basic pay which is contributed to the Thrift Savings Fund shall not be included in the term "wages" for the purposes of section 209 of the Social Security Act or I.R.C. section 3121(a).

If contributions are required to be made to the Thrift Savings Fund by the Entity, these contributions, as employer contributions to a qualified plan, would not be includible in the gross income of the Employee and would not be subject to federal income tax withholding. The issue of FICA tax liability is more complex and would depend on the treatment of the contribution by the Thrift Savings Board (i.e., whether any part of the contributions were treated as elective deferrals by the employee and thus subject to FICA tax. Section 3121(v)(1)(A).) In the absence of guidance from the Thrift Investment Board, we are unable to provide a definitive response to this issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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on Form SS-10 does not extend the period of limitations for purposes of the employee's liability for the tax.

We were unable to find specific authority with respect to the liabilities of the employee after the employer pays the income tax withholding in a subsequent year. Some Tax Court Memorandum decisions state that the Government has a choice between collecting the income tax from the employer or from the employee. See Goins v. Commissioner, T.C.Memo. 1997-521 (in a case in which the petitioner's employer failed to withhold, the court stated "[r]espondent may collect payment from either the employee or the employer, but the employee remains ultimately liable for his own taxes even though his employer was obligated to withhold.") If, in contradiction to section 31, the regulations thereunder, and existing authority, an employee was allowed to credit an employer's subsequent year payment of income tax withholding in computing his income tax liability for the year the wages were received, it appears that a court may conclude that the employee would then be liable to the employer for the amount of the income tax withholding.

Because the income tax withholding cannot be adjusted for a prior year payment under section 6205 except to correct an administrative error (See Instructions for Form 941c, Supporting Statement to Correct Information)[5] and to remove any ambiguity, we suggest that in the instant case the Entity should not pay any amounts with respect to the income tax withholding on the wage payment, but should collect the liability for income tax of the employee from the employee. The Entity would therefore have no liability for income tax withholding under section 3402(d). The information already received by the employee is adequate for him to file his Form 1040. On the other hand, we suggest that the FICA taxes with respect to the payment should be corrected with the Entity paying both the employer and employee portions. We also suggest that a corrected Form W-2 relating to the year of the settlement payment should be furnished to the employee. He should also receive a Form W-2 for the year (hereinafter Year 3) that the Entity pays the FICA employee tax related to the wage payment, unless the Entity receives a reimbursement from the employee for the amount of the employee FICA tax during Year 3. This payment of the FICA employee tax is wages for income tax withholding purposes and FICA tax purposes, unless the Entity is reimbursed by the Employee. However, because the payment of the employee FICA tax in the subsequent year would be a regular wage payment for an annual payroll period or for a miscellaneous payroll period of 365 days, no income tax withholding liability would exist under the applicable withholding tables. See Rev. Rul. 78-336, 1978-2 C.B. 255, and Publication 15, Circular E, Employer's Tax Guide. The amount of wages to be reported in Boxes 1, 3, and 5 of the Year 2 Form W-2 would be based on treating the amount of the FICA employee tax paid with respect to the settlement payment as the "stated pay" and

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5 [redacted]

applying the calculation in Rev. Rul. 86-14 and contained on page 22 of the 2000 Publication 15-A, Employer's Supplemental Tax Guide.

The Entity can recover from the employee the amount of the employee portion of the FICA it pays with respect to the settlement payment, provided the payment of the tax is made within 3 years of the April 15 following the year of the settlement payment.

Please call if you have any further questions.