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

OFFICE OF
CHIEF COUNSEL

November 30, 2000

Number: **200124003**
Release Date: 6/15/2001
TL-N-2278-00
CC:TEGE:EOEG:ET2
UILC: 3121.01-12

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (TEGE), NORTHEAST/MID ATLANTIC AREA CC:TEGE:NEMA:BRK

FROM: Senior Technician Reviewer, Employment Tax
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities) CC:TEGE:EOEG:ET

SUBJECT: , Proposed FICA Tax Adjustment for 1994-1995

This Field Service Advice responds to your memorandum dated May 18, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND:

Taxpayer =

Date 1 =

Date 2 =

Year A =

Year B =

Year C =

Year D =

ISSUE:

Whether the FICA tax adjustments proposed for years B and C should be maintained?

CONCLUSION:

The proposed FICA tax adjustments should be maintained.

FACTS:

On Date 1, Taxpayer adopted a plan providing for separation pay (severance pay) for employees who are terminated. Under the plan, employees received advance notice of their impending termination date. The amount of severance pay an employee received depended upon the employee's length of service with Taxpayer. Taxpayer made severance payments under the plan in years A, B and C to employees who were involuntarily terminated or terminated after refusing a transfer.

Taxpayer originally treated the severance payments as subject to Federal Insurance Contributions Act (FICA)[1] taxes when paid in years A, B and C. On Date 2, Taxpayer filed claims for refund for such taxes, alleging that the payments were subject to FICA tax when the amount of an employee's severance

[1] FICA taxes consist of Old Age, Survivors, and Disability Insurance (OASDI) tax, and Hospital Insurance (HI) tax. Code section 3121(a)(1) imposes a dollar limit on the annual amount of wages subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on the annual amount of wages subject to the HI portion of FICA tax, effective for 1994 and later years. Thus, all wages are subject to the HI tax.

benefit was determined in years A, B, or C. These claims were processed by the IRS Service Center and paid in year D. Although the refunds were paid, an examination was opened and a FICA adjustment is proposed for years B and C. No adjustment is proposed for year A as the statute of limitations for year A expired.

Initially, Taxpayer asserted that its claims for refund with respect to amounts paid under the severance plan, filed under Code section 3121(v) after the publication date of the Proposed Regulations but before the effective date of the Final Regulations, met the requirements for a reasonable, good faith interpretation of Code section 3121(v)(2). However, in 1999 FSA LEXIS 174, 199940004, (Oct. 8, 1999), the Service addressed the treatment of a similar plan and concluded that the reasonable, good faith requirements were not met. Taxpayer now agrees that if its severance plan is a severance pay plan within the meaning of the Final Regulations under Code section 3121(v)(2), then it does not meet the reasonable, good faith standard. We have assumed for the purposes of this request that the classification as severance pay is correct. Taxpayer argues now that the severance payments made to employees upon termination were "window benefits" eligible for treatment under the special rules found in regulation section 31.3121(v)(2)-1(b)(4)(v)(B). When the Taxpayer filed the claim for refund it did not assert that the payments were window benefits because only the Proposed Regulations had been issued, and those did not include the transition rule for window benefits. As requested, the scope of our response is limited to whether the payments are window benefits.

LAW AND ANALYSIS

Background

Wages are generally subject to FICA tax when they are actually or constructively paid. See section 31.3121(a)-2(a). Section 3121(v)(2) of the Code was enacted as a special timing rule as part of the 1983 Amendments when Congress repealed the general retirement FICA tax exclusions provided in Code section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Code section 3121(v)(2)(A) provides that any amount deferred under a nonqualified deferred compensation plan shall be taken into account as wages for purposes of the FICA tax as of the later of (i) when the services are performed, or (ii) when there is no substantial risk of forfeiture of the rights to such amount. The term "nonqualified deferred compensation plan" means any plan or other arrangement for deferral of compensation other than a plan described in Code section 3121(a)(5), which generally refers to qualified retirement plans and tax-favored annuities. See Code section 3121(v)(2)(C). Any amount taken into account as wages by reason of Code section 3121(v)(2)(A) (and the income attributable thereto) shall not thereafter be treated as wages for FICA tax purposes. See Code section 3121(v)(2)(B).

In Notice 94-96, 1994-2 C.B. 564, the Service announced its intention to publish guidance under Code section 3121(v)(2) and stated that the effective date

of the proposed regulations will not be before January 1, 1995. The Service announced, it will not challenge an employer's determination of FICA tax liability with respect to a nonqualified deferred compensation plan for periods preceding the effective date, if the employer's determination is based on a reasonable, good faith interpretation of Code section 3121(v)(2).

The Service published Proposed Regulations under Code section 3121(v)(2) on January 25, 1996, in a Notice of Proposed Rulemaking, reprinted at 1996-1 C.B. 743. Section 31.3121(v)(2)-1(g) of the Proposed Regulations provides that the regulations are effective for amounts deferred and benefits paid after January 1, 1997. That proposed effective date was subsequently amended to January 1, 1998. Notice of Proposed Rulemaking, reprinted at 1998-8 I.R.B. 40. Final Regulations under Code section 3121(v)(2) were published January 29, 1999, applicable on or after January 1, 2000.[2] T.D. 8814, 1999-9 I.R.B. 4. Paragraph (g) of the Final Regulations provides transition rules for amounts deferred and benefits paid before January 1, 2000, and generally requires that the employer acted in accordance with a reasonable, good faith interpretation of Code section 3121(v)(2).

The proposed adjustments will be analyzed under the authority of the Final Regulations, including the transition rules contained in the Final Regulations, except to the extent the Proposed Regulations apply to determine whether Taxpayer acted in accordance with a reasonable, good faith interpretation of Code section 3121(v)(2).

Deferred Compensation

As discussed above, Congress enacted Code section 3121(v)(2) as a special FICA tax timing rule for nonqualified deferred compensation at the same time it repealed the FICA tax exclusions for nonqualified retirement benefits formerly contained in Code section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Section 31.3121(v)(2)-1(a)(2) reiterates the special timing rule for amounts deferred under a nonqualified deferred compensation plan. Paragraph (b)(1) defines the term "nonqualified deferred compensation plan" as any plan or other arrangement, other than a plan described in Code section 3121(a)(5), that is established by an employer for one or more of its employees, and that provides for the deferral of compensation. A plan provides for the "deferral of compensation" with respect to an employee only if, under the terms of the plan and the relevant facts and

[2] Section 31.3121(v)(2)-1(g)(1) provides that paragraphs (a) through (f) of the section apply to amounts deferred on or after January 1, 2000; to amounts deferred before January 1, 2000, which cease to be subject to a substantial risk of forfeiture on or after January 1, 2000, or for which a resolution date occurs on or after January 1, 2000; and to benefits actually or constructively paid on or after January 1, 2000.

circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable in a later year. See section 31.3121(v)(2)-1(b)(3).

Transition Rules

Because the payments were benefits paid prior to January 1, 2000, the relevant inquiry is how to apply the transition rules under the Final Regulations. Specifically, the issue is whether Taxpayer's original FICA tax treatment or Taxpayer's amended treatment, via filing a claim for refund, is in accordance with a reasonable, good faith interpretation of Code section 3121(v)(2) for purposes of the transition rules. If Taxpayer's amended treatment did not meet the reasonable, good faith standard, the proposed adjustment should be maintained.

With regard to any benefits actually or constructively paid before January 1, 2000, Section 31.3121(v)(2)-1(g)(2) provides that an employer may rely on a reasonable, good faith interpretation of Code section 3121(v)(2), taking into account pre-existing guidance. An employer will be deemed to have determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of Code section 3121(v)(2) if the employer has complied with paragraphs (a) through (f) of the regulation. For purposes of the transition rules of paragraphs (g)(2) through (4), and subject to paragraphs (g)(2)(ii) and (iii), whether an employer that has not complied with paragraphs (a) through (f) has determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of Code section 3121(v)(2) will be determined based on the relevant facts and circumstances, including consistency of treatment by the employer and the extent to which the employer has resolved unclear issues in its favor.

Section 31.3121(v)(2)-1(g) provides a number of specific transition rules. The transition rule in paragraph (g)(3)(i) applies if an employer determined FICA tax liability with respect to Code section 3121(v)(2) in any period ending prior to January 1, 2000, for which the applicable period of limitations has not expired on January 1, 2000, in a manner that was not in accordance with the regulations, and permits the employer, subject to the consistency requirements in paragraph (g)(3)(ii), to adjust its FICA tax determination for that period to conform with the regulations. However, paragraph (g)(3)(ii) permits a claim for refund or credit for FICA tax paid only to the extent it exceeds the FICA tax that would have been due had the employer determined FICA tax liability in accordance with the regulation.

Paragraph (g)(4) applies the reasonable, good faith interpretation standard. The transition rule in paragraph (g)(4)(i) concerns plans that are not subject to Code section 3121(v)(2) but for which, for a period ending prior to January 1, 2000, and, pursuant to a reasonable, good faith interpretation of Code section 3121(v)(2),

an employer took an amount into account as an amount deferred under a nonqualified deferred compensation plan. If paragraph (g)(4)(i) applies, (A) no additional FICA tax is due on benefit payments made before January 1, 2000, that are attributable to amounts previously taken into account; (B) benefit payments made after January 1, 2000, are subject to FICA tax when paid; and (C) the employer can get a refund, subject to the applicable period of limitations and the limitations of paragraph (g)(3), for FICA tax paid on amounts taken into account prior to January 1, 2000.

Analysis - Window Benefits

Section 31.3121(v)(2)-1(b)(4)(v)(A) sets forth the general rule that benefits provided in connection with impending termination of employment do not result from the deferral of compensation under Code section 3121(v)(2). Section 31.3121(v)(2)-1(b)(4)(v)(B)(1) states that a window benefit is provided in connection with impending termination and defines the term window benefit as an early retirement benefit, retirement-type subsidy, social security supplement, or other form of benefit made available by an employer for a limited period of time (not to exceed one year) to employees who terminate employment.

A benefit will not be considered a window benefit under this regulation if an employer establishes a pattern of repeatedly providing for similar benefits in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these benefits constitutes a pattern of amendments is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the benefits relate to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business. See section 31.3121(v)(2)-1(b)(4)(v)(B)(2).

Paragraph (b)(4)(v)(B)(3) provides a transition rule for window benefits made available before January 1, 2000. Under this rule, an employer may treat a window benefit that was made available for a period of time beginning before January 1, 2000, as nonqualified deferred compensation subject to Code section 3121(v)(2), if the sole reason the window benefit fails to be provided under a nonqualified deferred compensation agreement is the general rule in paragraph (b)(4)(v)(B)(1), that window benefits are provided in connection with impending termination and are not nonqualified deferred compensation. This transition rule can be read in combination with the transition rule in paragraph (g)(3) to permit an employer to amend its returns with respect to window benefits made available prior to January 1, 2000, and to treat the window benefits as deferred compensation for any pre-effective date open periods. That adjustment is permitted even though window benefits are not nonqualified deferred compensation under the Final Regulations and may not be treated as such after the effective date of the regulations (January 1, 2000).

To use this special transition rule the benefit provided must be a bona fide window benefit. Although Taxpayer asserts that its severance plan was a window benefit, it has provided no evidence that the severance plan was an early retirement benefit, retirement type subsidy, social security supplement or other form of benefit. In fact, Taxpayer attempts to confuse the issue by arguing that the only possible reason for not applying the transition rule for window benefits is that its severance plan was a recurring window benefit described in section 31.3121(v)(2)-1(b)(4)(v)(B)(2), which is not eligible for the special transition rule. Taxpayer hopes that the Service will ignore the bona fides of the severance plan and instead rely on Revenue Ruling 92-66, 1992-2 C.B. 92 to determine that the benefit was not recurring and allow Taxpayer to avail itself of the special transition rule.[3]

It is our view that the severance payments Taxpayer made to terminated employees were not window benefits, and Taxpayer is not eligible for treatment under the special transition rule for window benefits. The severance plan was not offered as a means to induce employees to retire. There was no open window period during which employees had the opportunity to accept or reject future payments from the plan. There was absolutely nothing voluntary about these payments. Employees could not choose to continue their employment. Instead, employees were notified of their termination date, and following termination, they received severance payments based upon their length of service with the Taxpayer. These payments were severance, not window benefits.

Thus, the proposed adjustments, which generally return Taxpayer to its original FICA treatment, should be maintained. Taxpayer's original treatment of the severance pay, as subject to FICA tax when paid, is in accordance with a reasonable, good faith interpretation of Code section 3121(v)(2) and is consistent with the Service's longstanding position adopted in the Final Regulations that severance payments are not nonqualified deferred compensation, but are wages subject to FICA tax when paid.[4] The legislative history of the Social Security Amendments of 1950 which imposed FICA tax on severance pay states "[a] dismissal payment (any payment made by an employer on account of involuntary separation of the employee from the service of the employer) will constitute wages.

---

[3] Rev. Rul. 99-66 does not apply to this case. It concerns a bona fide early retirement window benefit provided by a section 401(a) qualified retirement plan. The issue addressed is whether the recurring nature of the benefit results in it becoming a feature of the plan within the meaning of section 411(d)(6) of the Code.

[4] Taxpayer's original FICA treatment was consistent with paragraphs (a) though (f) of the regulation, and is therefore a reasonable, good faith interpretation of Code section 3121(v)(2) under paragraph (g)(2)(i) with no optional adjustment required or permitted. See 31.3121(v)(2)-1(g)(2)(i)&(3).

. . . " H.R. Rep. No. 81-1300 at 124; S.Rep. No. 81-1669; see also McCorkill v. U.S., 32 F. Supp.2d 46, 47 (D. Conn. 1999) ("[b]ased on the legislative history[,] as well as upon Treasury Regulations[,] the Internal Revenue Service has consistently maintained that severance or dismissal payments are subject to FICA as being for services rendered"); Rev. Rul.71-408, 1971-2 C.B. 340 (holding that involuntary dismissal payments should be treated as ordinary wages). The courts have also applied this approach.

In Cohen v. United States, 63 F. Supp.2d 1131 (C.D. Cal. 1999), the plaintiff entered into an agreement with his employer in which he received five annual lump-sum payments in exchange for his voluntary resignation. The plaintiff asserted that the payments were nonqualified deferred compensation within the meaning of Code section 3121(v)(2), and therefore, should have been subject to FICA tax when the plaintiff separated from service. The court found that the severance payments were not nonqualified deferred compensation, citing to the regulations under Code section 3121(v)(2). The Cohen court concluded that the severance plan at issue did not provide an arrangement for deferred salary and thus did not qualify for the special timing rule.

Since Taxpayer's original FICA treatment is in accordance with the Final Regulation, no optional adjustment is needed or permitted under paragraph (g)(3). Further, Taxpayer's amended treatment was not in accordance with a reasonable, good faith interpretation of Code Section 3121(v)(2). The severance payments are not window benefits; therefore the special transition rule for window benefits does not apply. Accordingly, the proposed FICA adjustments for years B and C should be maintained.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted] However, the Final Regulations include transition rules which govern how the Service will respond to an employer's treatment of amounts deferred or benefits paid prior to January 1, 2000. Certainly the Service should follow its own regulations and the specific transition rules in responding to a taxpayer's claim for refund or in this case maintaining a proposed adjustment.[5]

[5] We note that Congress has prohibited administrative exclusions from FICA tax. See S.Rep. No. 98-23, 98th Cong., 1st Sess., at 42 (1983 U.S.Code Cong. & Adm.News 183); H.Rep. No. 98-25, 98th Cong., 1st Sess., at 80 (1983 U.S. Code Cong. & Adm.News 299).

[redacted]

Although hazards exist, the stronger technical argument supports maintaining the proposed adjustments. In addition, the administrative importance of these issues supports maintaining the proposed adjustment in accordance with the legal position discussed above. Taxpayer's original FICA treatment of the severance payments is correct under the Final Regulations, and Taxpayer's amended treatment was not in accordance with a reasonable, good faith interpretation of Code section 3121(v)(2). We see no reason for the Service to agree that these payment are window benefits.[6]

We will be pleased to provide any further assistance. Please call Dan Boeskin (identification No. 50-16785) at (202) 622-6040 if you have any further questions.

Marie Cashman

[6] The Appeals Officer asked this office to consider whether a hazard of litigation exists when the employee portion of a FICA refund paid to a taxpayer was refunded to the employees. We see no particular hazard raised by the refund to the employees. The employer is obligated to withhold and pay FICA taxes pursuant to sections 3102 and 3111.