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

OFFICE OF
CHIEF COUNSEL

May 4, 2001

Number: **200133009**
Release Date: 8/17/2001
CC:TEGE:EOEG:ET2
WTA-N-110385-00
UILC: 3121.01-12

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR SB/SE AREA 5, AP:MIA

FROM: Senior Technician Reviewer (CC:TEGE:EOEG:ET)

SUBJECT: Proposed FICA and FUTA Adjustment for [redacted]

This Chief Counsel Advice responds to your memorandum dated April 27, 2000. In accordance with Internal Revenue Code (the Code) section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

X =
Corporation =

Association =
Articles =

City =
State =

ISSUE

Whether amounts the Corporation paid to X in 1995 and 1996 are wages subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes.

CONCLUSION

The amounts the Corporation paid to X in years 1995 and 1996 are wages subject to FICA and FUTA taxes.

FACTS

The Association was formed on May 17, 1982, pursuant to the Articles of Association (the Articles) executed by the Members. The Association provides pilot services to vessels moving in and out of the port of City. Each Member of the Association is a State corporation, and the sole shareholder and employee of each Member is a pilot licensed under State Law. Each Member agrees to engage only in the business of piloting vessels for the Association and to make its shareholder available for pilot duties on a 24-hour per day basis. Based upon our understanding of the Articles, the objectives in forming the Association included providing pilots the opportunity to perform piloting services on an equal basis and distributing the fees received for performing such services on an equal basis among the Association's Members.[1] The business of the Association is conducted by an executive committee designated by the Members. The committee makes assignments, bills for work completed, collects fees and performs the other duties of the Association. On or before the last day of each month, the Association distributes an equal share of net earnings to each Member subject to certain adjustments. The Articles provide that a Member shall cease to be a Member upon the death, retirement, or resignation of its sole shareholder.

Article XII of the Articles is entitled "Deferred Compensation Plan." This section provides that any pilot who attains age 55 and has completed 20 years of active service as a pilot may retire from active service and become a consultant pilot and participate in the earnings of the Association. We note that the term "pilot" is undefined. Article XII also requires a consultant pilot to give advice and consultation concerning the operation of the Association and the duties of an active pilot. Under this Article, a pilot who meets the age and service requirements and elects to retire receives for the remainder of his life 2 percent of the Association's gross revenues, provided that amount does not exceed 50 percent of an active pilot's share.

X became a licensed State pilot in February 1962. The Corporation was formed as a C corporation in August 1981. X was the sole shareholder, officer,

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[1] The facts as specified are based upon this office's understanding of the Articles of Association. As a general matter, the Articles are imprecise, making it difficult to determine the meaning of certain provisions.

director and employee of the Corporation that is the taxpayer in this case. The Corporation, acting through X in his capacity as president of the Corporation, signed the Articles of Association as a Member on May 17, 1982. No materials were provided to this office related to the formation or operation of the Corporation.

On December 14, 1994, X resigned as an officer and director of the Corporation, and the Corporation elected to be treated as an S corporation effective January 1, 1995. We have assumed that X ceased performing services as a pilot for the Corporation coincident with his resignation. When X elected to retire, he satisfied the age and years of service requirements in Article XII. Notwithstanding the requirement in Article XII that retired pilots render consulting services, the Association waived that requirement for X.

For tax years 1995 and 1996, the Association distributed the amounts described in Article XII to the Corporation. The Association did not pay any amounts directly to X. On Form 1099 for 1995, the Association reported in box 7 as nonemployee compensation a distribution to the Corporation of $ 211,085.70. In a similar manner, the Association reported a distribution of $ 202,696.47 for 1996. The Association specified that $159,086 in 1995 and $154,696 in 1996 of the amounts distributed to the Corporation were for “retirement income.”

For 1995 and 1996 respectively, the Corporation reported on Schedule K, *Shareholders’ Shares of Income, Credits, Deductions etc.,* a distribution to X of $ 93,469, and $ 210,254. The Corporation did not treat any amounts paid to X as wages subject to FICA and FUTA taxes.

The Service conducted an employment tax examination of the Corporation for years 1995 and 1996 and proposed an adjustment of FICA and FUTA tax liability. The adjustments were based upon the examiner’s determination that the Corporation paid $159,086 for 1995 and $154,696 for 1996 to X in “wages.”

Initially, the Corporation asserted that the amounts were not wages because wages are remuneration for services, and X did not perform any services during the years at issue. The Corporation now contends, however, that the amounts distributed to X were not subject to FICA and FUTA taxes because the amounts were paid “on account of retirement” under a plan that was established prior to March 24, 1983, and are subject to a FICA and FUTA retirement-pay exception extant at that time.

APPLICABLE LAW

FICA Taxes

FICA taxes are composed of the Old-Age, Survivor, and Disability Insurance (OASDI) tax and the Medicare tax. Code Section 3101(a) imposes a 6.2 percent tax on an individual's wages for OASDI, and Code section 3111(a) imposes an excise tax on an employer equal to 6.2 percent of the wages paid by the employer for OASDI. Code section 3101(b) imposes a 1.45 percent tax on an individual's wages for Medicare, and Code section 3111(b) imposes an excise tax on an employer equal to 1.45 percent of the wages paid by the employer for Medicare. The OASDI portion of FICA taxes applies only to a certain amount of wages in a tax year. After an employee's wages exceed this annually-adjusted amount, the OASDI portion of FICA taxes does not apply. Since 1994, the Medicare tax has applied to all of an employee's wages.

Code section 3121(a) defines wages as all remuneration, in whatever form, for employment unless a specific exception applies. Code section 3121(b) defines employment as any service, of whatever nature, performed by an employee for an employer unless a specific exception applies.

In general, FICA taxes are imposed when the employee is paid. For FICA purposes, wages are generally received by an employee at the time that they are paid by the employer to the employee, and wages are paid by an employer at the time that they are actually or constructively paid. Regulation sections 31.3101-3, 31.3111-3 and 31.3121(a)-2(a).

Code section 3121(v)(2) was enacted by the Social Security Amendments of 1983. In those Amendments, Congress repealed the general FICA tax exclusions for retirement payments provided in Code sections 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Under Code section 3121(v)(2)(A), any amount deferred under a nonqualified deferred compensation plan is taken into account as wages for FICA tax purposes 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. Code section 3121(v)(2)(B) further provides that 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 purposes.

Regulation section 31.3121(v)(2)-1(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), which generally refers to qualified retirement plans and tax-favored annuities, that is established by an employer for one or more of its employees, and that provides for the deferral of compensation. A nonqualified deferred compensation plan may be adopted unilaterally by the employer or may be negotiated by the employer and employees. A plan may constitute a nonqualified deferred compensation plan for FICA purposes without regard to whether the deferrals under the plan are made pursuant to an election by the employee or whether the amounts deferred are treated as deferred

compensation for income tax purposes. A plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing. Regulation section 31.3121(v)(2)-1(b)(2). Regulation section 31.3121(v)(2)-1(b)(3) specifies that 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 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.

Code section 3121(v)(2) is generally effective for payments made after December 31, 1983. 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. Regulation section 31.3121(v)(2)-1(g) 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 retirement pay exclusions provided in Code sections 3121(a)(2)(A), (a)(3) and (a)(13)(A)(iii) as in effect on April 19, 1983 (the day before the enactment of the Social Security Amendments of 1983) applied to retirement payments prior to December 31, 1983. The transition rules in regulation section 31.3121(v)(2)-2 are applicable on and after January 1, 2000. These rules are used to determine whether amounts deferred and payments made are treated under Code section 3121(v)(2) or are eligible for the favorable treatment afforded transition benefits.

The transition rules provide that "transition benefits" paid pursuant to a "March 24, 1983, agreement" are not subject to FICA taxes provided that payments under the agreement would have met one of the retirement pay exclusions in effect on April 19, 1983. Regulation section 31.3121(v)(2)-2(b)(6) defines a March 24, 1983, agreement as an agreement in existence on March 24, 1983, between an individual and a nonqualified deferred compensation plan within the meaning of regulation section 31.3121(v)(2)-1(b). Such an agreement does not fail to be a March 24, 1983, agreement merely because the terms of the plan are changed after March 24, 1983. For purposes of paragraph (b)(6), any plan or agreement that provides for payments that qualify for one of the former retirement payment exclusions is treated as a nonqualified deferred compensation plan. Transition

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[2] Section 31.3121(v)(2)-1(g)(1) provides that paragraphs (a) through (f) of this 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.

benefits are benefits paid after December 31, 1983, attributable to services rendered before January 1, 1984. For this purpose, transition benefits are determined without regard to any changes made in the terms of the plan after March 24, 1983. Regulation section 31.3121(v)(2)-2(b)(8).

Regulation section 31.3121(v)(2)-2(b)(5) defines an "individual party to a March 24, 1983, agreement" as an individual who was eligible to participate in a March 24, 1983, agreement under the terms of the agreement on March 24, 1983. An individual will be treated as an individual party to a March 24, 1983, agreement even if the individual has not accrued any benefits under the plan by March 24, 1983, and regardless of whether the individual has taken any specific action to become a party to the agreement.

In sum, the transition rules apply to certain payments made under a nonqualified deferred compensation plan established before March 24, 1983, which provides for retirement payments that qualify for one of the former retirement pay exception.

FUTA Taxes

Code section 3301(a) imposes the FUTA tax on an employer equal to 6.2 percent of the wages paid by the employer. This tax applies only to the first $7000 of an employee's wages and is reduced further by any credits properly claimed by the employer. Code section 3306(b) defines wages as all remuneration, in whatever form, for employment unless a specific exception applies. Code section 3306(c) defines employment as any service, of whatever nature, performed by an employee for an employer unless a specific exception applies.

In general, FUTA taxes are imposed when the employee is paid. For this purpose, wages are generally received by an employee at the time that they are paid by the employer to the employee, and wages are paid by an employer at the time that they are actually or constructively paid. Regulation sections 31.3301-2, 31.3301-3(b) and 31.3301-4.

Code section 3306(r)(2) is the special timing rule for FUTA purposes. It provides that any amount deferred under a nonqualified deferred compensation plan is taken into account as wages for FUTA tax purposes 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. Code section 3306(r)(2)(B) further provides that amount taken into account as wages by reason of Code section 3306(r)(2)(A) and the income attributable thereto shall not thereafter be treated as wages.

The text of Code section 3306(r)(2) is identical to Code section 3121(v)(2). However, Code section 3306(r) has a later effective date; it applies to payments

made after December 31, 1984. Regulation sections 31.3306(r)(2)-1 & (2)-2 cross-reference Regulation sections 31.3121(v)(2)-1 & (2)-2. Accordingly, the analysis and conclusions provided herein concerning FICA tax liability under Code section 3121(v)(2) and the regulations thereunder, also apply for FUTA purposes. In this case, no issue arises from the different effective dates.

ANALYSIS

Generally, the Articles describe the relationship between the Association and its Members. Article XII provides that a pilot who meets the age and service requirements and elects to retire, will receive for the remainder of his life, two percent of the Association's gross revenues limited to 50 percent of an active pilot's share. Based upon the terms of Article XII and its execution of the Articles of Association on May 17, 1982, the Corporation asserts that a March 24, 1983, agreement existed between X and a nonqualified deferred compensation plan.

No evidence suggests that a March 24, 1983, agreement existed between X and a nonqualified deferred compensation plan. A nonqualified deferred compensation plan is 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. Regulation section 31.3121(v)(2)-1(b)(1). Article XII does not meet this requirement. The pilots were not employees of the Association, and Article XII was not an arrangement established by an employer to benefit its employees.

X was neither a party to a March 24, 1983, agreement nor an individual eligible to participate in a March 23, 1983, agreement. The Association operates as a partnership; its Members are partners. The Articles require pilots to be employees of the Members. From the date the Corporation was formed until X retired, X performed services as a pilot for the Corporation and not as an employee of the Association. No employer-employee relationship existed between the Association and X. X was an officer of the Corporation, and as such, was an employee of the Corporation.

Notwithstanding the terms of Article XII specifying that payments will be made to the pilot, the Association paid the amounts required by Article XII to the Corporation. It reported these amounts paid to the Corporation on Form 1099, *Miscellaneous Income*. Thus, the Association did not treat Article XII as a nonqualified deferred compensation plan.

Between the Association and each pilot stood an intentionally created corporate entity. For over 20 years, X performed piloting services as an employee of his Corporation. X now seeks to ignore the existence of the Corporation to avoid the payment of FICA taxes. For FICA purposes, X, in effect, asserts that he

was an employee of the Association. In Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974), the Supreme Court explained "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have followed but did not." Neither the Service nor the taxpayer is free to disregard the Corporation's existence.

Accordingly, it is our view that the amounts the Corporation paid to X in 1995 and 1996 do not qualify for the transition rule exception for agreements in existence on March 24, 1983, between an individual and nonqualified deferred compensation plan primarily because Article XII is not a nonqualified deferred compensation plan for purposes of the transition rules. In addition, even if Article XII were a nonqualified deferred compensation plan, X was not an individual party to a March 24, 1983, agreement. Further, after lengthy consideration of the facts and issues in this case, we believe it extremely unlikely that the arrangement described in Article XII, which in fact is an arrangement between the Association and its corporate partners, is the kind of arrangement that Congress intended to treat as a nonqualified deferred compensation arrangement subject to either the special timing rule in Code section 3121(v)(2) or the transition rules in Regulation section 31.3121(v)(2)-2. Instead, the amounts the Corporation paid to X in 1995 and 1996 arose out of the employer-employee relationship that existed between X and the Corporation until December 1994. Those amounts are wages subject to FICA tax when paid under the general timing rule. *See* Regulation sections 31.3101-3, 31.3111-3 and 31.3121(a)-2(a).

Code section 3121(a) defines wages as all remuneration for employment, unless a specific exception applies. Employment is defined in Code section 3121(b) as "any service, of whatever nature performed . . . by an employee for the person employing him." *STA of Baltimore - ILA Container Royalty Fund v. United States*, 621 F. Supp. 1567, 1570 (D. Md. 1985), *aff'd*, 804 F.2d 296 (4th Cir. 1986). "Taken together, subsections (a) and (b) of [Code] section 3121 define 'wages' . . . as 'all remuneration' for 'any service.'" *Id.*

Regulation section 31.3121(a)-1(i) provides that remuneration for employment, unless 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.

In *Social Security Bd. v. Nierotko*, 327 U.S. 358 (1946) the Supreme Court considered whether back pay for a time in which the employee was not on the job should nevertheless count as "wages" in determining the employee's eligibility for Social Security benefits. *Id*. at 359. In concluding that the back pay was wages for

social security benefit purposes the Court noted the broad definition of wages as "all remuneration for employment " and employment as "any service . . . performed . . . by an employee for his employer" under the Social Security Act. *Id*. at 364. The Court states as follows with respect to the definition of "employment."

> The very words "any service . . . performed . . . for his employer, " with the purposes of the Social Security Act in mind, import breadth of coverage. The[se words] admonish us against holding that "service" can be only productive activity. We think that "service" as used by Congress in this definitive phrase means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer.

Id. at 365-66.

Many recent cases have also recognized the breadth of the definition of wages under the FICA. In *Associated Electric Cooperative Inc. v. United States*, 42 Fed. Cl. 867 (1999), *aff'd,* 226 F.3d 1322 (Fed. Cir. 2000), the court held that certain termination payments paid pursuant to a voluntary early out plan were wages subject to FICA. The court stated "the notion of an 'employer-employee relationship' continues to be . . . the touchstone for determining if a particular payment is subject to FICA taxation." *Id.* at 872. The court further determined that "[s]ervices performed need not be linked to a particular or productive activity to fall within FICA tax liability." *Id.* at 874. *See also Mayberry v. United States*, 151 F.3d 855, 860 (8th Cir. 1998); *Hemelt v. United States*, 122 F.3d 204, 209 (4th Cir. 1997) and *Lane Processing Trust v. United States*, 25 F.3d. 662 (8th cir. 1994).

Thus, even though the Corporation paid amounts to X when he was no longer performing services as a pilot or corporate officer, the payments arose from the employer-employee relationship that existed between X and the Corporation. There is no doubt that the payments made were for past services X performed for the Corporation. As such, they are remuneration for employment and no exception in Code section 3121(a) applies to exclude these payments from the definition of wages.

In reviewing the materials submitted, we note the proposed adjustments use employment tax rates provided by Code section 3509. Because the facts do not raise a worker classification issue, Code section 3509 is inapplicable and full rates should apply.[3]

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[3] The Appeals Officer asked whether a Notice of Determination under Code section 7436 should be issued to the Corporation. Code section 7436(a) requires an "actual controversy" regarding the status of a worker as an employee. This case does not raise the issue of whether X was an employee of the Corporation.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Regulation section 31.3121(v)(2)-1(g)(2) provides that, for periods before January 1, 2000 (including amounts deferred before January 1, 2000, and any benefits actually or constructively paid before January 1, 2000, that are attributable to those amounts deferred), an employer may rely on a reasonable, good faith interpretation of Code section 3121(v)(2), taking into account pre-existing guidance. 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.

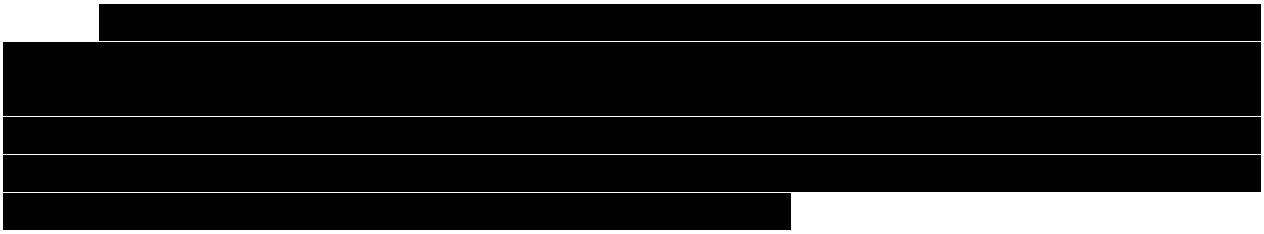
No evidence suggests that the Corporation's treatment of amounts paid to X as exempt from FICA and FUTA was based on a reasonable, good faith interpretation of the statute and existing guidance. In fact, the evidence suggests the opposite – the Corporation did not consider whether Code section 3121(v)(2) applied to the distributions made to X in 1995 or 1996. The Corporation did not withhold or pay FICA tax on any portion of the distributions.[4] Its position was not based on a reasonable, good faith interpretation of the statute and existing guidance because it did not take any position with respect to Code section 3121(v)(2). Apparently, the Corporation was unaware of Code section 3121(v)(2). In the examination, the Corporation asserted that the amounts distributed to X were not wages because X did not perform any services for the Corporation during the years at issue. Not until this case was in appeals did the Corporation raise Code section 3121(v)(2).

Under the facts and circumstance test articulated in the existing guidance, Notice 94-96, 1994-2 C.B. 564, and regulation section 31.3121(v)(2)-1(g)(2)(i) of the transition rules, the Corporation resolved all issues in it favor. This treatment

[4] Although the Association labeled the distributions made pursuant to Article XII as retirement income, it did not withhold and pay any FICA tax on the distributions. The Association was not legally obligated to pay FICA taxes on the distributions because it was not X's employer. The inaction of the Corporation and the Association is perhaps the most revealing evidence in this case.

indicates the Corporation's position was not consistent with a reasonable, good-faith interpretation of the statute.

Finally, the assertion that Article XII is a March 24, 1983, agreement is inconsistent with the plain language of Code section 3121(v)(2), which requires an employer-employee relationship to exist. By its terms, section 3121(v)(2) applies specifically to wages. In general, wages are defined in Code section 3121(a) as remuneration for employment and employment is defined in section 3121(b) as service performed by an employee for the person employing him. It is our view that a reasonable, good faith interpretation of Code section 3121(v)(2) cannot include an interpretation that did not require an employment relationship to exist in order for a nonqualified deferred compensation plan to exist. Because the Code itself contains the employment relationship requirement, the Corporation cannot argue in good faith that subsequent regulations and administrative guidance (or a lack thereof) changed the plain language of the statute.



If a suit for refund is filed in this case, we recommend that area counsel coordinate the defense letter with this office.

Please call Dan Boeskin (identification No. 50-16785) of my staff at (202) 622-6040 if you have any further questions.

Marie Cashman