Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:
January 14, 2003

Legend

Taxpayer:
Former School District:
State:
County:
Plan:
Date 1:

Dear :

This letter is written in response to the Taxpayer's request for a ruling on the application of the continuing employment exception to the hospital insurance portion (also known as Medicare tax) of the Federal Insurance Contributions Act (FICA) tax as set forth in Internal Revenue Code (Code) § 3121(u)(2)(C). The specific request includes the following rulings:

1. The Taxpayer is the same employer as the Former School District for purposes of Code § 3121(u)(2)(C).

2. The services of the eleven teachers who were continuously employed prior to April 1, 1986 qualify for the exception to Medicare tax as set forth in Code § 3121(u)(2)(C), which tax is imposed under Code §§ 3101(b) and 3111(b).

FACTS:

Prior to 1990, the Taxpayer was the Former School District and provided education for children from kindergarten through the eighth grade. The Former School District provided no high school classes for children residing within the boundaries of the school district. Following the passage of a referendum in 1990, the Former School District

became unified under State law and established two high schools within the boundaries of the Former School District. The Taxpayer's borders are the same as the Former School District's borders. The assets and liabilities of the Former School District were transferred to the Taxpayer upon unification.

The County in which the Taxpayer is located remains responsible for the withholding of all federal income and employment taxes for the employees of the Taxpayer as it was for the employees of the Former School District.

Pursuant to a division of the Plan that became effective on Date 1, employees of the Taxpayer who were hired before April 1, 1986, were permitted to elect Medicare insurance coverage provided that they (a) were members of the Plan; (b) were employed in a position covered by the Plan on March 31, 1986; (c) did not have mandatory Medicare coverage under the Consolidated Omnibus Reconciliation Act of 1985; and (d) were members of the Plan or eligible for membership in the Plan on the date of the division. Employees who meet these criteria have the option of being covered under a voluntary agreement pursuant to section 218(d) of the Social Security Act (Section 218 Agreement) for Medicare insurance only.

Generally, a teacher is employed by the Taxpayer for a one-year term that is automatically renewed unless the teacher is terminated. Except for eleven teachers, all employees of the Taxpayer were hired after April 1, 1986. The eleven teachers, who were hired before April 1, 1986, were all eligible to elect voluntary Medicare insurance coverage and four of the eleven teachers elected to be covered for medicare insurance under the Section 218 Agreement. Seven of the eleven employees remain employed by the Taxpayer after the unification with no break in service. Four of the eleven teachers terminated their employment with the Taxpayer, but were continuously employed with the Taxpayer until their termination.

LAW AND ANALYSIS:

FICA taxes consist of the old-age, survivors, and disability (OASDI) portion and the Medicare tax portion and are computed as a percentage of wages paid by the employer and received by the employee for employment. Code §§ 3101, 3111, 3121. Generally, all remuneration paid by an employer for services performed by an employee is subject to FICA unless the remuneration is specifically excepted from the term "wages" or the services are specifically excepted from the term "employment." Code §§ 3102, 3111, 3121.

Service performed by an employee of a state, political subdivision, or wholly owned instrumentality not covered by a Section 218 Agreement is exempt from employment for purposes of the OASDI portion of FICA only if the employee is a member of a retirement system of such state, political subdivision, or wholly owned instrumentality in connection with the employee's employment. Code § 3121(b)(7)(F). Service

performed by an employee of a state, political subdivision, or wholly owned instrumentality who is hired after March 31, 1986, is considered to be employment for purposes of applying Medicare tax. Code § 3121(u)(2). Service covered by a Section 218 Agreement is specifically excluded from employment for purposes of Medicare tax as set forth under Code § 3121(u)(2)(A), but is subject to Medicare tax under the terms of such Section 218 Agreement. Code § 3121(u)(2)(B). The Internal Revenue Code, however, provides a narrow exception for services subject to Medicare tax pursuant to Code § 3121(u)(2)(A), known as the continuing employment exception, if specific requirements are met. Code § 3121(u)(2)(C).

For employment to qualify for the continuing employment exception under Code § 3121(u)(2)(C), an employee's service performed for a state, political subdivision, or wholly owned instrumentality must meet the following requirements:

1. The employee's service must be excluded from the term "employment" as determined in Code § 3121(b)(7)(F), which exclusion applies only to an employee who is a member of a retirement system of such state, political subdivision, or wholly owned instrumentality. Code § 3121(u)(2)(C)(i) (cross-reference to subparagraph (A) of Code § 3121(u)(2) with cross-reference to Code § 3121(b)(7)).

2. The employee performed substantial and regular service for compensation for that employer before April 1, 1986.

3. The employee was a bona fide employee of that employer on March 31, 1986.

4. The employee's employment relationship with that employer was not entered into for purposes of meeting the requirements of Code § 3121(u)(2)(C).

5. The employee's relationship with that employer has not been terminated after March 31,1986.

Section 3121(u)(2)(D)(ii) of the Internal Revenue Code provides that a political subdivision, as defined in section 218(b) of the Social Security Act, 42 U.S.C. § 418(b)(2), includes all agencies and instrumentalities of a political subdivision and shall be treated as a single employer for purposes of applying the continuing employment exception.

Revenue Ruling 86-88, 1986-2 C.B. 172, which provides guidelines for applying the continuing employment exception, refers to section 218(b)(2) of the Social Security Act to define the term "political subdivision" to include a county, city, town, village, or school district. The term "political subdivision employer" is defined as a political

subdivision and any agency or instrumentality of that political subdivision that is a separate employer for purposes of withholding, reporting, and paying the federal income taxes of employees.

In the instant case, we assume that: (1) the Plan is a retirement system pursuant to Code
§ 3121(b)(7)(F); (2) the employment of the eleven teachers of the Former School District consisted of substantial and regular services performed for compensation for the Former School District prior to April 1, 1986; (3) such teachers were bona fide employees of the Former School District on March 31, 1986; and (4) the teachers' services were not entered into for purposes of avoiding Medicare tax. Thus, the application of the continuing employment exception turns on whether or not the eleven teachers' employment was terminated upon the unification of the Former School District as the Taxpayer.

Based on the facts presented and assumptions made, we conclude that the Former School District and the Taxpayer are considered to be the same employer for purposes of applying the continuing employment exception to Medicare tax. As we understand the facts, the Former School District expanded in 1990 by opening two high schools within district boundaries that did not previously exist. This expansion of the Former School District did not create a new employer. Employees of the Former School District who subsequently became employees of the Taxpayer remained employed by the same employer, and, therefore, such employees' employment did not terminate for purposes of the continuing employment exception.

To conclude, the continuing employment exception applies to the services of the eleven teachers who were hired before April 1, 1986. The continuing employment exception ceased to be applicable with respect to the four teachers who elected voluntary Medicare insurance coverage under the Section 218 Agreement (and, therefore, application of Medicare tax to their wages) as of the effective date of such election. The teachers whose employment terminated and who had not previously elected voluntary coverage under the Section 218 Agreement ceased to be eligible for the continuing employment exception as of the date of termination.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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

Sincerely,

Lynne Camillo
Chief, Employment Tax Branch 2
Office of Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)

cc: