

Internal Revenue Service

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Department of the Treasury
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Refer Reply To:

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Date:

September 02, 2004

Legend

X =

Y =

Political

Subdivision 1 =

Political

Subdivision 2 =

Political

Subdivision 3 =

Political

Subdivision 4 =

Political

Subdivision 5 =

Political

Subdivision 6 =

Political

Subdivision 7 =

State L =

Statute M =

Agreement N =

Date 1 =

Date 2 =

Date 3 =

Dear :

This is in response to your request for a letter ruling dated April 20, 2004, on the continuing employment exception to the Medicare portion of the Federal Insurance Contributions Act (FICA) taxes under Internal Revenue Code (Code) section 3121(u)(2)(C).

Facts

On Date 2 X assumed the responsibility of Political Subdivision 7 to provide fire, emergency medical, and emergency protection services to Political Subdivision 7 and six municipal corporations located in Political Subdivision 7: Political Subdivisions 1, 2, 3, 4, 5 and 6. Prior to Date 2 these services were being provided by Y to Political Subdivisions 1, 2, 3, 4, 5, 6 and 7 using equipment and assets owned separately by Political Subdivisions 1, 2, 3, 4, 5, 6 and 7.

X was specifically created to consolidate the personnel of Y with the equipment and assets used to provide these services. X was created pursuant to the terms of Agreement N. Agreement N contains a recital that provides in part that Political Subdivisions 1, 2, 3, 4, 5, 6 and 7 “desire to create a political subdivision ... to continue effective fire, emergency medical, and emergency protection services.”

N provides that “all personnel... providing fire protection and emergency medical services or emergency management services ... shall be offered continuing employment ... as of [Date 3],” with X.

X was created under the authority of Statute M. Statute M provides in part:

Any two or more State L public agencies may by agreement create a State L interlocal entity to accomplish the purpose of their joint or cooperative action....

Statute M also provides:

- An interlocal entity created under this section is :
- (a) separate from the public agencies that create it;
 - (b) a body politic and corporate; and
 - (c) a political subdivision of the state.

Statute M defines “public agency” to include: A city, town, county, school district, special district, or other political subdivision of the state.

The information submitted in the request for a ruling represents that Political Subdivisions 1, 2, 3, 4, 5, 6, and 7 are public agencies within the meaning of Statute M

and are political subdivisions of State L. These political subdivisions entered into Agreement N effective Date 1.

Law and Analysis

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

Services performed by an employee of a state, political subdivision, or wholly owned instrumentality not covered by a 218 Agreement are generally exempt from employment for purposes of the OASDI portion of the FICA only if the employee is a member of a retirement system of such state, political subdivision, or wholly owned instrumentality. Code section 3121(b)(7)(F). Services performed by an employee of a state, political subdivision, or wholly owned instrumentality are generally considered to be employment for purposes of applying Medicare tax. Code section 3121(u)(2). However, the Code provides an exception to the Medicare tax, known as the continuing employment exception, if specific requirements are satisfied. Code section 3121(u)(2)(C).

For employment to qualify for the continuing employment exception, an employee’s services performed for a particular state, political subdivision, or wholly owned instrumentality must satisfy the following requirements enumerated in Code section 3121(u)(2)(C):

1. The employee’s services must be excluded from the term “employment” as defined in Code section 3121(b)(7)(F), which exclusion generally applies only to an employee who is a member of a retirement system of such state, political subdivision, or wholly owned instrumentality. See cross-reference in Code section 3121(u)(2)(C)(i) to Code section 3121(u)(2)(A) which cross-references Code section 3121(b)(7). This rule is effective for services performed after July 1, 1991. Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, section 11332(b)(3), 101st Cong., 2d Sess. (1990); see also Revenue Ruling 2003-46, 2003-19 I.R.B. 878, May 12, 2003.
2. The employee performs substantial and regular services for compensation for the employer before April 1, 1986.
3. The employee is a bona fide employee of the employer on March 31, 1986.
4. The employee’s employment relationship was not entered into for purposes of satisfying the requirements of Code section 3121(u)(2)(C).
5. The employee’s relationship with the employer has not terminated after March 31, 1986.

Code section 3121(u)(2)((D) provides the following rule with regard to the determination of employer for purposes of the continuing employment exception. The rule provides that:

- (i) All agencies and instrumentalities of a State (as defined in section 218(b) of the Social Security Act) or the District of Columbia shall be treated as a single employer.
- (ii) All agencies and instrumentalities of a political subdivision of a State (as so defined) shall be treated as a single employer and shall not be treated as described in clause (i).

Revenue Ruling 86-88, 1986-2 C.B. 172, provides guidance concerning the continuing employment exception and the applicability of the Medicare tax. Revenue Ruling 86-88 provides that the term “political subdivision” has the same meaning that it has under section 218(b)(2) of the Social Security Act, 42 U.S.C. section 418(b)(2). Thus, the term “political subdivision” ordinarily includes a county, town, village, or school district. Revenue Ruling 86-88 also provides that the term “political subdivision employer” includes the 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. Under these definitions, for example, if an employee simply ceased working as a firefighter for one political subdivision and began working as a firefighter for another political subdivision employer, that employee would have transferred from one political subdivision to another political subdivision, and, thus, that employee could not satisfy the continuous employment requirement of Code section 3121(u)(2)(C)(iii).

However, the case of Board of Education of Muhlenberg County v. United States, 920 F.2d 370 (6th Cir. 1990), holds that the Code does not explicitly address the application of the continuing employment exception in cases of merger or consolidation of political subdivisions. Under this case a consolidated school district that was formed when three formerly independent school districts merged into one was found not to be a new employer for purposes of the continuing employment exception. The court turned to legislative history to determine that the purpose of Code section 3121(u)(2)(C) was to protect state and local government agencies from a sudden increase in Medicare taxes. H.R. Rep. No. 99-241, 99th Cong., 1st Sess., Pt. 1, at 25-27.

The court concluded that Congress did not intend to treat a merger or consolidation of two or more employers as creating a new employer for purposes of Code section 3121(u)(2)(C) because such treatment would create the same sudden financial burden on state and local governments that the exception was drafted to mitigate and would deter consolidation of local government entities for purposes of enhancing efficiency. Accordingly, the court held that the taxpayer was not a new employer for its post-merger employees, who in substance continued to work for the same employer under a different name. Thus, the consolidation of the school districts did not result in the creation of a new employer, nor did the consolidation disqualify employees from eligibility for the continuing employment exception of Code section 3121(u)(2)(C).

We conclude that the consolidation in this case is governed by Board of Education of Muhlenberg County v. United States. Pursuant to Statute M, Political Subdivisions 1, 2, 3, 4, 5, 6 and 7 created political subdivision X and subsequently Political Subdivisions 1, 2, 3, 4, 5, 6 and 7 conveyed equipment and assets to X and Political Subdivision Y transferred employee personnel to X. Incidental to this consolidation X now provides the fire, emergency medical, and emergency protection services previously provided Y with equipment and assets transferred by Political Subdivisions 1, 2, 3, 4, 5, 6 and 7. Pursuant to the terms of Agreement N, personnel continuously employed by Political Subdivision 7 prior to April 1, 1986, were offered continued employment with X.

Consequently, we hold that the personnel of Political Subdivision 7 hired before April 1, 1986, and previously entitled to the continuing employment exception to Medicare pursuant to Code section 3121(u)(2)(C) continue to be eligible for such exception if they are employees of X and members of a retirement system within the meaning of Code section 3121(u)(2)(C).

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, this is not a ruling as to whether the retirement system satisfies the requirements of Code section 3121(b)(7)(F) and the regulations thereunder.

The ruling contained in this letter is 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.

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.

Sincerely,

Lynne Camillo
Chief, Employment Tax Branch 2
Office of Division Counsel/Associate Chief
Counsel
(Tax Exempt & Government Entities)

cc: