INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-121433-01/CC:PA:APJP:B02

Director of Field Operations

Taxpayer's Name:

Taxpayer's Address:
Taxpayer's Identification No:

Year Involved:
Date of Conference:

LEGEND:

Employer =
Year 1 =
Industry =
Property B =
Union =
Agreement =
Year 2 =
Year 3 =
$X =
$Y =
Year 4 =

ISSUES:

1. Whether the court-awarded damages received by employees of Employer as a result of the employees' suit for breach of contract against Employer are wages subject to employment taxes;

2. If so, whether the Union is liable for the withholding and payment of employment taxes as the statutory employer pursuant to I.R.C. § 3401(d)(1);

3. Whether accuracy-related penalties apply based on the Union's failure to withhold and pay employment taxes on the damage award it distributed to employees.

CONCLUSIONS:

1. The court-awarded damages received by former employees of Employer as a result of the employees' breach of contract suit against Employer are wages subject to employment taxes;

2. The Union is liable for the withholding and payment of employment taxes as the statutory employer pursuant to I.R.C. § 3401(d)(1);

3. Accuracy-related penalties apply.

FACTS:

In Year 1, the Employer purchased certain Industry properties, including Property B. Certain of the Employer's employees are members of the Union. The Union serves as the collective bargaining agent for its members. In its capacity as collective bargaining agent, the Union, on behalf of the employee members, negotiated and signed the Agreement with the Employer. Pursuant to the "successorship clause" of the Agreement, the Employer agreed not to sell any of the Industry operations covered by the Agreement without first securing the prospective purchaser's written agreement to assume the Employer's obligations under the Agreement, including specifically the obligation to continue to employ the employees working at Industry properties covered by the agreement.

In Year 2, the Employer sold Property B to the buyer. The Employer sold Property B to the buyer without a requirement that the buyer assume the Employer's obligations under the Agreement. The Union filed suit for breach of contract against the Employer. The principal claim set forth in the complaint was that the sale of Property B by the Employer to the buyer was in violation of the Agreement.

In a pretrial conference, the court found that punitive damages were not appropriate in this case. The rationale behind the court's finding was that the Employer had sold its interest in Property B to the buyer so there was no danger of further violations of the collective bargaining Agreement by the Employer . Thus, the court concluded that an award of punitive damages was not warranted because it would not deter future misconduct or prevent industrial strife.

The jury found in favor of the Union by deciding that the operation of Property B was covered by the Agreement, and that the sale without a requirement for the buyer to assume the Employer's obligations violated the Agreement. Pursuant to the jury verdict, the Employer was found liable for breach of contract. Damages were awarded to the plaintiffs in the amount of $X.

In Year 3, $X plus $Y interest, calculated from the date of the verdict, was paid by the Employer's bank to the Union. In Year 4, the Union made lump sum payments to workers affected by the breach. The Union distributed the amount of the jury award,

plus interest, evenly among the employees affected by the breach. Employer simply made a lump sum payment to the Union. The Union determined how the lump sum payment would be divided. Employer had no knowledge of the amount paid to each employee; that was determined by the Union in accordance with the plan of distribution.

The Union issued Forms 1099-MISC to the employees and reported the payments as non-employee compensation. Neither the Employer nor the Union withheld, reported or paid any employment taxes on the payments made to employees affected by the breach.

Of all the employees who received lump sum payments, about one-fifth of the employees received no other wages from Employer in Year 4, and the remaining four-fifths received an average of $60,000 from Employer in Year 4.

The Union argues that the damages awarded pursuant to the jury verdict are not wages because no portion of the damages represents wages that Employer would have paid to its former employees for services that would have been rendered to it. Instead, the Union contends that the damages represent wages that the Employer's former employees would have received (but for the breach) from an unrelated third party (i.e., from the buyer of Property B) for services rendered to that unrelated third party. In support of this argument, the Union notes that all of the factors listed in the jury instruction related to what the employees would have earned in the future working for the buyer, who was not a party to the case. Under these circumstances, the Union asserts that the damages awarded do not fit within the statutory definition of wages.

LAW AND ANALYSIS:

Whether The Payments Are Wages

Both the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) define "wages" as "all remuneration for employment" unless specifically excluded. I.R.C. §§ 3121(a) and 3306(b). "Employment" as used in this definition means "any service of whatever nature performed by an employee for the person employing him. I.R.C. § 3121(b).

Section 31.3121(a)-1(i) of the Employment Tax Regulations, pertaining to FICA, 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. See also 31.3306(b)-1(i) relating to the FUTA.

In determining the tax treatment of damages received from a lawsuit or in settlement of a lawsuit, one looks to the nature of the item for which the damages are a substitute. Hort v. Commissioner, 313 U.S. 28 (1941). In Social Security Board v. Nierotko, 327 U.S. 358, 365-66 (1946), the Supreme Court held that back pay awarded under the National Labor Relations Act to an employee who had been wrongfully discharged

constituted "wages" under the Social Security Act. The Court noted that the back pay constituted remuneration and also held that the remuneration was for "employment" even though the back pay related to a period during which the petitioner did not perform any service. The Court emphasized the breadth of the definition of "employment":

> The very words "any service . . . performed . . . for his employer," with the purpose of the Social Security Act in mind, import breadth of coverage. They admonish us against holding that "service" can be only productive activity. We think "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.

Nierotko has been cited in a number of recent cases dealing with the question of whether payments upon termination of employment or upon settlement of lawsuits for various employee rights are wages for federal employment tax purposes. Courts of Appeals have held that the definition of wages should be construed very broadly, and that back and front pay awards come within the broad definition of wages for federal employment tax purposes. Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997).

In Gerbec v. United States, 164 F.3d 1015 (6th Cir. 1999), the court considered whether payments in settlement of a suit under the Employee Retirement Income Security Act (ERISA) against the Continental Can Co. were includible in income and wages for FICA tax purposes. In discussing the FICA tax issue and citing Nierotko, the court held that "the phrase 'remuneration for employment' includes certain compensation in the employer-employee relationship for which no actual services were performed." 164 F.3d 1026. The court in Gerbec further stated as follows:

> . . . The holding in Nierotko clearly supports the conclusion that awards representing a loss in wages, both back wages and future wages, that otherwise would have been paid, reflect compensation paid to the employee because of the employer-employee relationship, regardless of whether the employee actually worked during the period in question.

In Hemelt, the Fourth Circuit also emphasized the "expansive language of the definition of wages and employment. That case involved the same settlement at issue in Gerbec. The court concluded that the "ERISA claims at issue . . . related directly to taxpayers' employment relationship with Continental" and thus constituted wages for FICA tax purposes. See also Mayberry v. United States, 151 F.3d at 860.

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 to employees were wages for FICA tax purposes. The court stated as follows with respect to the definition of wages under the FICA (42 Fed. Cl. at 872):

> The notion of an "employer-employee relationship" continues to be recognized as the touchstone for determining if a particular payment is subject to FICA taxation. In addition, courts recently construing I.R.C. § 3121 have followed Nierotko by affording the terms "wages" and "employment" broad, inclusive coverage.

Under the broad definition of wages set forth in the above authority, the payments made to the workers who were employees of the taxpayer are directly related to their employment relationships with the taxpayer. This is reflected in the complaint filed by the Union against the Employer, which sought damages for, among other things, lost wages, lost health insurance, lost pension credit for time worked and pension benefits, lost fringe benefits, such as holiday, vacation, sick or personal leave pay, sickness and accident benefits and life insurance benefits. Insofar as the nature of the underlying claim reflects that the lump sum payments were intended as a substitute for lost wages and employee benefits, the awards constitute "remuneration for employment" within the meaning of FICA.

The method used to calculate the awards here further supports the view that the settlement payments are properly characterized as wages. In calculating the damages awarded in this case, the jury was instructed by the court that it was their:

> duty to determine the amount of money which would reasonably, fairly and adequately compensate the [Union] represented employees for loss of earnings, including benefits, in the future which were occasioned by the breach of the collective bargaining agreement. In order to calculate the lost future earnings of these workers, [the jurors could] consider:
>
> 1. The number of persons who have lost employment opportunities because of the defendants' breach of contract;
>
> 2. The number of years until they will be likely to retire; and
>
> 3. The wages and benefits they could reasonably have expected to earn in the future if there had been no contract violation, taking into account the wages and benefits they currently earn.

Because the method used to calculate the appropriate lump sum settlement amount in this case is based on what the Employees' earnings would have been had the Employer not breached the collective bargaining agreement, the lump sum settlement amount awarded by the jury is wages for employment tax purposes. See generally Hort v. Commissioner, 313 U.S. 28 (1941).

The Union's argument that the damages awarded are not wages because they represent amounts that the Employer's former employees would have received (but for the breach) from an unrelated third party (i.e., the purchaser of Property B) for services rendered to that unrelated third party is without merit. Payments made by an employer

to compensate employees for loss of wages that such employees would have earned from another party but for the employer's wrongful violation of an employment agreement have been held to constitute wages. For example, in San Francisco Giants v. United States, 88 F. Supp. 2d 1087 (N.D. Ca. 2000), appeal pending, (9th Cir.) and St. Louis Cardinals v. United States, 88 A.F.T.R.2d 5185 (E.D. Mo. 2001), appeal pending, (8th Cir.), the District Courts held that payments made to former baseball players to compensate them for loss of free agency rights constituted wages. The theory in those cases was that the players may have earned a higher rate of compensation from other baseball teams if their employers had not interfered with their "free agency rights", i.e., their rights to entertain offers of employment with other teams.

Moreover, the Union's reliance on Eirhart v. Libbey-Owens-Ford Co., 1991 U.S. Dist. LEXIS 14244, Nos. 76C 3182, 78C 2042 (N.D. Ill. Oct. 7, 1991), is misplaced. Eirhart does not establish a "general rule that payments made for reasons other than the performance of services do not constitute wages." See Associated Electric Cooperative, Inc. v. United States, 42 Fed. Cl. 867, 874 (1999) aff'd 226 F.3d 1322 (Fed. Cir. 2000). Eirhart involved damages paid to a class of employee hired into temporary, rather than full-time employment at one of the taxpayer's plants in violation of a consent decree. The court concluded that the payments at issue represented compensation for lost wages that could have been earned from other employment but for the employer's wrongful conduct. However, the Court in Eirhart acknowledged that payments are wages for the purposes of employment tax withholding "where an employer is responsible for back pay to its own employee (even though by definition the employee has not actually rendered services during the period). . . ." In the instant case, the Employer was held responsible by virtue of a collective bargaining agreement for the payment of wages that could, but for the Employer's breach, have been earned by its employees from another employer. Under these circumstances, the definition of wages should be construed very broadly, and back and front pay awards like the award in the instant case come within the broad definition of wages for federal employment tax purposes. Social Security Board v. Nierotko, 327 U.S. 358, 365-66 (1946); Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997).

Statutory Employer Under § 3401(d)(1)

Generally, the employer for purposes of federal employment taxes is determined under the common law rules.

Section 3401(d) of the Code provides, in part, for purposes of income tax withholding, that the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person except that – (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of the definition of wages) means the person having control of the payment of such wages.

The regulations under section 3401(d) relating to the definition of "employer" interpret the phrase "in control of the payment of wages" as referring to "legal control." These regulations clearly contemplate that "in control of the payment of wages" means more than simply making the actual payment of wages. See Treas. Reg. § 31.3401(d)-1(f). For example, with respect to supplemental unemployment compensation benefits, the regulations provide that if the person making such payment is acting solely as an agent for another person, the term "employer" shall mean such other person and not the person actually making the payment. See Treas. Reg. § 31.3401(d)-1(g).

Neither the FICA nor the FUTA contain a definition of employer similar to the definition contained in section 3401(d)(1) of the Code, relating to income tax withholding. However, Otte v. United States, 419 U.S. 43 (1974), holds that a person who is an employer under section 3401(d)(1) of the Code is also an employer for purposes of FICA employee tax withholding under section 3102. Thus, under Otte, if the common law employer does not have control of the payment of wages, the person in control of the payment of wages is an employer with respect to liability for the FICA employee tax. The Otte decision has been interpreted to provide that the person having control of the payment of the wages is also an employer for purposes of section 3111 of the Code (the employer portion of FICA tax), and section 3301 (FUTA tax). In re Armadillo Corp., 410 F. Supp. 407 (D. Colo. 1976), aff'd, 561 F.2d 1382 (10th Cir. 1977).

The issue of what constitutes "control of the payment of wages" under section 3401(d)(1) has been examined by courts in various cases. It has been held that "control" requires something more than the mere supplying of money for the payroll. Westover v. Simpson, 209 F.2d 908 (9th Cir. 1954). Generally, the courts have concluded that the test is who makes up the payroll, who determines the employees to be included therein, and who determines the amounts they are to be paid. Arthur Venneri Co. v. United States, 340 F.2d 337 (Ct. Cl. 1965); Phinney v. Southern Warehouse Corp., 212 F.2d 488 (5th Cir. 1954). See also General Motors Corp. v. United States, 91-1 U.S.T.C. ¶50,032 (E.D. Mich. 1990).

However, In matter of Southwest Restaurant Systems, Inc. v. United States, 607 F.2d 1237 (9th Cir. 1979), took a more expansive view of the term "in control of the payment of wages." In that case, the debtor corporation paid the compensation of employees of three other related corporations. The court overturned lower courts' opinions that the debtor in question was not "in control of the payment of wages" for purposes of federal employment taxes. The court stated that the lower courts improperly relied on such "irrelevant factors" as control over the hiring and firing, control over the performance of services, and control over the amount of the pay and the terms of the payment. The court stated:

> No one other than the person who has control of the payment of wages is in a position to make the proper accounting and payment to the United States. It matters little who hired the wage earner or what his duties were or how responsible he may have been to his common law employer. Neither is it important who fixed the rate of compensation. When it finally

> comes to the point of deducting from the wages earned that part which belongs to the United States and matching it with the employer's share of FICA taxes, the only person who can do that is the person who is in "control of the payment of such wages." 607 F.2d at p. 1240.

In General Motors, the General Motors Corporation (GM) entered into a contract with an overseas company, United Technical Services (UTS), to obtain additional design engineers to supplement its American workers. UTS paid the wages and benefits of the UTS workers. GM claimed that it never treated the UTS workers as employees and did not know the amount of their wages. According to GM, it had no direct control over UTS workers except to the extent necessary to insure conformity with GM standards. The status of the workers as employees was not at issue. The Service attempted to collect unpaid employment taxes with respect to the workers from GM.

In General Motors, the court held that only the person in control of the payment of wages (UTS in that case) was liable for the employment taxes. The court interpreted Otte as providing that "the responsibility for withholding employment taxes is directed toward the person who pays the workers and not the person who has control over the workers' duties." 91-1 U.S.T.C. at p. 87,145.

Based on the above, the liability for the payment of the employer and employee FICA tax, the FUTA tax, and federal income tax withholding is imposed on the party in control of the payment of the wages. In this case, Employer simply made a lump sum payment to the Union. The Union determined how the lump sum payment would be divided. Employer had no knowledge of the amount paid to each employee; that was determined by the Union in accordance with the plan of distribution. Based on the information submitted, we conclude that the Union was in control of the payment of the wages and is liable for the employer and employee FICA tax, FUTA tax, and federal income tax withholding with respect to the payment.

Accuracy-related Penalties for Negligence

Section 6662(a) and (b)(1) impose a 20-percent accuracy-related penalty on the portion of an underpayment that is due to negligence or intentional disregard of rules or regulations. Negligence includes a failure to attempt reasonably to comply with the Code. I.R.C. § 6662(c). Disregard includes a careless, reckless, or intentional disregard. Id.

Section 6664(c)(1) provides that the accuracy-related penalty shall not be imposed with respect to any portion of an underpayment if it is shown that a taxpayer acted in good faith and that there was reasonable cause for the underpayment. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case by case basis, taking into account all pertinent facts and circumstances. See Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 226 (1999). Generally, the most important factor is the taxpayer's effort to assess the proper tax liability. Income Tax Regulations § 1.6664-4(b)(1); 113 T.C. at 226. In this regard, the credibility of the

taxpayer's reasons for not determining the proper tax liability may be evaluated. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer. Income Tax Regulations § 1.6664-4(b)(1).

The Union paid $X plus interest from the proceeds of a judgment to the employees who were affected by the Employer's breach of the Agreement. The Union did not withhold or pay employment taxes on the payments. The $X paid to the workers constitutes wages subject to employment tax, and the payments should have been reported on Forms W-2, and on Forms 940 and 941 with applicable withholding and payment of FICA tax and income tax. Instead, the Union reported the amounts as "Non-employee compensation" in box 7 of Forms 1099-MISC. The 1995 Form 1099 filing instructions contained the following language:

> Generally, amounts reportable in box 7 are subject to self-employment taxes. If payments are not subject to this tax (self-employment tax) and they are not reportable elsewhere on Form 1099-MISC, report the payments in box 3.

If, at the time the payments were made, the taxpayer believed that the payments were not wages, the taxpayer should have reported the amount in box 3 of Form 1099-MISC as "Other income" with a corresponding explanation of the nature of the payment. The Union has not asserted any reasonable basis for treating the payments as self-employment income, and for failing to report the payments on Forms W-2. The Union's relationship with the miners was based on the fact that the miners were employees of the Employer. Negotiations, contracts and suits the Union entered into on behalf of the workers were based on the premise that the workers were employees.[1] In particular, the $X plus interest was received as a result of a suit for "lost wages and benefits."

Inasmuch as the Union is frequently required to report payments to its members, the Union is not unsophisticated with respect to reporting payments to employees. The Union has not provided an explanation as to why the payments were reported as nonemployee compensation other than to say that they, ". . . simply advised the individual recipients to consult with their own tax advisors," and " . . . because of the

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[1] Once unit employees have designated the union as a bargaining representative and the union has been recognized or certified by the National Labor Relations Board, the employer is obligated under the National Labor Relations Act ("the Act") to deal with the union as its employees' exclusive representative. Under the Act, the employer must confer with the union in good faith with respect to wages, hours, and other terms and conditions of employment. In fact, once such an exclusive representative has been recognized or certified, the employer cannot deal individually with its employees but must, instead, deal with them collectively through their union with regard to their terms and conditions of employment. See 29 U.S.C. §§ 158(a)(5); 158(d); and 159(a).

strong likelihood that the payments were taxable, the Union reported the payments to the IRS in the manner that seemed most appropriate." It is reasonable to expect that a taxpayer exercising ordinary business care and prudence would make every effort to ascertain the correct treatment when reporting payments totaling $X dollars plus interest rather than simply advising the recipients to consult their own tax advisors.

The Union has not asserted any reasonable cause for failing to ascertain the correct reporting treatment for the payments. The Union has indicated that its Comptrollers Office "simply inserted the amounts in the box [the Union] usually uses when advised that the payments were not wages." This treatment suggests an insufficient effort to assess the proper tax liability.

We note also that $Y of the payments represented interest and should have been reported to the recipients as interest income. Form 1099-MISC has several boxes that are used to report payments characterized as non-wage payments, i.e., rents, royalties, other income, federal income tax withheld, fishing boat proceeds, medical and health care payments, non-employee compensation, substitute payments in lieu of dividends or interest, etc. A taxpayer making an effort to assess the proper tax liability would try to determine the correct characterization of each component of the payment rather than simply inserting the amounts in the box it usually used.

Finally, we are not persuaded that the taxpayer's reliance on Eirhart establishes reasonable cause for the underpayment. As discussed in detail above, the weight of authority establishes that the definition of wages should be construed very broadly, and that back and front pay awards come within the broad definition of wages for federal employment tax purposes. Social Security Board v. Nierotko, 327 U.S. 358, 365-66 (1946); Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997).

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.