Internal Revenue Service

Department of the Treasury

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Date:
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Legend:

State X =
The Act =

Political Subdivision 1 =
Political Subdivision 2 =
Political Subdivision 3 =
Political Subdivision 4 =
Political Subdivision 5 =
Political Subdivision 6 =
Political Subdivision 7 =
Facility =
Current Facility =
The Statute =
Facility Officer =

Dear :

This letter is written in response to your request on behalf of State X for reconsideration of our prior ruling requested by State X concerning the application of the continuing employment exception to the hospital insurance portion of the Federal Insurance Contributions Act (FICA) tax as set forth in Internal Revenue Code (Code) § 3121(u)(2)(C).

In State X's prior ruling request, State X asked us to rule that employees of the Facility of Political Subdivision 1 who were continuously employed by the Facility prior to April 1, 1986, ceased to be eligible for the continuing employment exception when Political Subdivision 1 was abolished and employees of the Facility were transferred to employment with State X. After an in-depth review of the facts and law, we ruled that

the continuing employment exception no longer applied to the employees of Political Subdivision 1 following their transfer to employment with State X. In your current request, you ask that we reconsider our prior ruling in light of additional information that was not submitted with State X's original request. You now request a ruling that employees of Political Subdivisions 1-7 who were continuously employed prior to April 1, 1986 retained eligibility for the continuing employment exception following the abolishment of Political Subdivisions 1-7 and the employees' transfer to employment with State X.

Facts

The pertinent facts submitted with State X's prior ruling request are as follows:

1. Legislation mandated by the Act resulted in the immediate abolishment of Political Subdivision 1 due to a fiscal emergency. The Act provided for the transfer to State X of all functions, duties, and responsibilities of Political Subdivision 1, including, among other Political Subdivision 1 offices, the operation and management of the Facility.

2. All liabilities, debts, assets, real and personal property, revenue, leases, and contracts of Political Subdivision 1 became the obligations and holdings of State X.

3. All employees of Political Subdivision 1 who were transferred to State X pursuant to the Act became members of the state retirement plan. The retirement plan assets of Political Subdivision 1 associated with such employees were transferred from the retirement plan of Political Subdivision 1 to the retirement plan of State X.

4. The terms of the commissioners of Political Subdivision 1 expired on the transfer date as set forth in the Act.

5. The Act provided for the transfer of employees of Political Subdivision 1, including the Facility Officer, from employment with Political Subdivision 1 to employment with State X with no impairment of employment rights held immediately before the transfer date (i.e., no impairment of seniority, retirement, or other employee rights; no reduction of compensation or salary grade; and no change in union representation).

6. The Facility Officer, who had administrative and operational control over the Facility, retained such control over the Current Facility.

7. Eligibility and coverage of insurance benefits (e.g., group life and accidental

death and dismemberment insurance; health, surgical, medical, dental, and other health insurance benefits) for employees who became state employees under the Act were transferred from Political Subdivision 1 to State X without interruption of coverage.

8. Political Subdivision 1 employees who were members of a collective bargaining agreement on the transfer date continued to receive coverage as required by the terms of the agreement.

9. The human resources division of the executive office for administration and finance of State X assumed the obligation of Political Subdivision 1 to pay into the health and welfare trust fund of a collectively bargained agreement for members who were transferred to State X.

You submitted the following additional information with your current request:

1. Political Subdivisions 2-7 were abolished by mandate of the Statute, which legislation codified other statutes similar to the Act that mandated the abolishment of Political Subdivision 1. Consequently, the operation and management of the Facilities of Political Subdivisions 2-7 were transferred to State X, creating state agencies.

2. Numerous examples of State X's financial reimbursements to Political Subdivisions 1-7 of expenses for the operation and expansion of their Facilities.

3. The Comptroller of the Revenue for State X is responsible for reporting, withholding, and paying employment taxes on wages paid to all employees who transferred to State X employment pursuant to the Act and the Statute. Prior to the abolishment of Political Subdivisions 1-7, the treasurers of Political Subdivisions 1-7 were responsible for reporting, withholding, and paying employment taxes for employees within each treasurer's area of authority.

4. A Facility Officer may negotiate a collectively bargained agreement as an "employer" but must submit the agreement to the governor of State X for funding and final approval. If funding approval is not given after 45 days, the collective bargaining agreement must be renegotiated.

5. State X employees are not subject to an agreement under § 218 of the Social Security Act, 42 U.S.C. § 418 (§ 218 Agreement).

Law and Analysis

FICA taxes consist of the old-age, survivors, and disability (OASDI) portion and 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 §§ 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.

Services performed by an employee of a state, political subdivision, or wholly owned instrumentality not covered by a § 218 Agreement are 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. Code § 3121(b)(7)(f). Services performed by employees of a state, local political subdivision, or wholly owned instrumentality who are hired after March 31, 1986 that are not subject to a § 218 Agreement are considered to be employment for purposes of applying medicare tax. Code § 3121(u)(2). The Code, however, provides a narrow exception to medicare tax, 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, an employee’s services performed for a state, political subdivision, or wholly owned instrumentality must meet the following requirements:

1. The employee’s services 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. See Code § 3121(u)(2)(C)(i) with cross-reference to subparagraph (A) of Code § 3121(u)(2) with cross-reference to Code § 3121(b)(7). This rule is effective for services performed after July 1, 1991. Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, § 11332(b)(3), 101st. Cong., 2d Sess. (1990).

2. The employee performs substantial and regular services for compensation for **THAT** employer before April 1, 1986.

3. The employee is a bona fide employee of **THAT** employer on March 31, 1986.

4. The employee’s employment relationship 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.

Code § 3121(u)(2)(C) (emphasis added).

The Code defines the term “employer” specifically for purposes of applying the continuing employment exception and provides that a state employer is a separate and different employer from a political subdivision employer. Code § 3121(u)(2)(D). Specifically, Code § 3121(u)(2)(D) sets forth the following definitions:

> For purposes of subparagraph (C), under regulations –
>
> (i) All agencies and instrumentalities of a State (as defined in section 218(b) of the Social Security Act) or of 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).** (Emphasis added.)

Revenue Rulings 86-88, 1986-2 C.B. 172 and 88-36, 1988-1 C.B. 343 provide guidelines for use in applying the continuing employment exception. Revenue Ruling 86-88 defines the term “political subdivision” based on § 218(b)(2) of the Social Security Act to include a county, city, town, village, or school district. 42 U.S.C. § 418(b)(2). 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. Revenue Ruling 86-88 defines a “state employer” as the state and any agency or instrumentality of that state that is a separate employer for purposes of withholding, paying, and reporting federal income taxes of employees. In applying the continuing employment exception rule and the above definitions, an employee hired before April 1, 1986, does not qualify for the continuing employment exception if, after March 31, 1986, the employee transfers from a political subdivision employer to a state employer. Q/A-7, Rev. Rul. 86-88. It does not matter that the employee is transferred to the state from a political subdivision without a change in salary, seniority or benefits. See Q/A-7, Rev. Rul. 86-88. The conclusions reached in Revenue Ruling 86-88 are dispositive of the facts and issues in the instant case.

In your ruling request, you assert that since State X law provides that a Facility Officer is an employer even after the Facility Officer’s transfer to State X, the continuing employment exception should apply because the employer is still the same as before the abolishment of Political Subdivisions 1-7. However, State X law, in reference to the

abolishment of Political Subdivisions 1-7, refers to the transfer of “political subdivision” employees to “state” employment. In other words, under State X law, Political Subdivisions 1-7 are the former employers of the transferred employees and State X is the current employer. Moreover, according to State X law, the final approval and funding authorization applicable to any negotiated collectively bargained agreement

entered into on behalf of former employees of Political Subdivisions 1-7 is reserved for the governor of State X. The facts further establish that the responsibilities for reporting, withholding, and paying federal employment taxes with respect to the employees' compensation were transferred from the treasurers of Political Subdivisions 1-7 to the Comptroller of the Revenue for State X, a state employer. This is another factor that establishes a change in employers for purposes of determining the application of the continuing employment exception. Rev. Rul. 86-88. Consequently, it is our view that the transfer of employees from Political Subdivisions 1-7 to State X constitutes a termination of employment for purposes of determining eligibility for the continuing employment exception.

You claim that the employees who were transferred pursuant to the Statute did not change employers in the "traditional sense of the word" but were transferred by operation of law from employment with Political Subdivisions 1-7 to State X when Political Subdivisions 1-7 were abolished; thus, employment was not terminated and the continuing employment exception should continue to apply to such employees. You cite the holding in Board of Education of Muhlenberg County, Ky. v. United States as authority for your position. 920 F.2d 370 (6th Cir. 1990), rev'g, 724 F. Supp. 472 (W.D. Ky. 1989). In Muhlenberg, the court held that a merger of three school districts, which were political subdivisions, into a single, new school district, also a political subdivision, did not create a new employer within the meaning of Code § 3121(u)(2)(C). While the court acknowledged the legitimacy of the government's argument that the school districts were political subdivisions and separate employers, the court determined that the merger of two or more political subdivision employers was not addressed in the statute. Consequently, it turned to legislative history.

The court concluded that Congress did not intend to treat a merger of political subdivisions as creating a new employer for purposes of Code § 3121(u)(2)(C). The court, after reviewing the House Report, noted that Congress intended for moves from state government to local government to constitute a termination of employment for purposes of applying the continuing employment exception, which is directly applicable to the facts of this ruling request. Muhlenberg, at 375 citing H.R. No. 241, 99th Cong., Part 1, at 25-27 (1985) (House Report).

The legislative history for the enactment of the application of the medicare portion of FICA to state and local government employees shows that the House and the Senate both agreed to stop the drain on the Medicare hospital insurance program by state and local government employees who qualify for Medicare in their later employment years but who contribute little or no funds into Medicare. Both houses proposed applying medicare tax to state and local government employment that had previously been excluded from the medicare portion of FICA. S. Rep. No. 99-146, at 390 (1985) (explanation of S. 1730); H.R. No. 241, 99th Cong., Part 1, at 25 (1985). The two legislative bodies, however, disagreed as to the extent of the application of the tax. H.R. Conf. Rep. No. 99-453, at 632-33 (1985). The House wanted mandatory

coverage of newly hired state and local government employees but the Senate wanted mandatory coverage of all employees, current and new. Id. The enacted legislation adopted the House version. Id.

In the House Report, the Committee explained that it was aware of the financial burden that mandatory coverage of all employees (such as the Senate version) might present. H. R. Rep. No. 99-241, Part I , at 25 (1985). Therefore, the Committee selected a transitional application of medicare taxation by including the continuing employment exception in the legislation. Id. This relief was to be temporary and applied at the time the states and political subdivisions were first brought under the legislation. As the Committee recognized, there will be "great pressure to avoid coverage." Id. at 26. The Committee also recognized that defining entities as separate employers will be very "complex." Id. Accordingly, the Committee explained that it will be generally true that employees who move between different jobs within a state government would be considered continuously employed "while employees who move from state government employment to a job with a local township, county, or municipality, or vice versa, would be considered newly hired." Id.

In the instant case, we assume that: (1) the retirement plans of Political Subdivisions 1-7 and the retirement plan of State X are "retirement systems" pursuant to Code § 3121(b)(7)(F); (2) the employment of employees who were transferred to State X pursuant to the Statute consisted of substantial and regular services performed for compensation for Political Subdivisions 1-7 prior to April 1, 1986; (3) such employees were bona fide employees of the Facilities of Political Subdivisions 1-7 on March 31, 1986; and (4) such employees' 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 employees' employment was terminated upon their transfer from employment with Political Subdivisions 1-7 to employment with State X.

The facts show, in the original request and in the current request for reconsideration, that the employees who were transferred to state employment are not maintaining employment with the same employer as required by Code § 3121(u)(2)(C)(iii). The employees transferred from employment with political subdivisions to employment with a state. According to the Code, Revenue Rulings 86-88 and 88-36, and legislative history, a state and a political subdivision are two distinct and different employers for purposes of applying the continuing employment exception. The Code expressly denies treatment of a political subdivision employer as a state employer and visa versa. Code § 3121(u)(2)(D).

In your request, you do not refute the information submitted with the original request, but allege that relevant information was lacking. You submit for our review financial information concerning State X's reimbursement to Political Subdivisions 1-7 for expenses incurred in the operation of the Facilities of Political Subdivisions 1-7 and assert that the level of financial dependence of a political subdivision on a state creates

an employment relationship, so that the transfer of employees to State X is not a change in employers. Also, you assert that the transfer of an employee by operation of law does not constitute a change in employment. However, these factors are not particularly relevant when considering the application of the continuing employment exception.

You also rely on the holding in Muhlenberg, which case involved the merger of three school districts, which were political subdivisions, into a new school district, also a political subdivision. As noted above, the court held that the continuing employment exception applied because the employer did not change. The facts in the current request differ substantially from the facts in the Muhlenberg case, which is reflected in our analysis in the original private letter ruling. The entities involved in the current case are political subdivisions and a state. No merger of entities took place. Instead, employees were transferred from political subdivisions to the state. Code § 3121(u)(2)(D) explicitly provides that the continuing employment exception does not apply under these circumstances.

While the facts in Muhlenberg are inapposite to the instant case, the underlying reasoning of the court is helpful with the current request. The court observed that employees' who move between different jobs in a state government would be considered continuously employed by the state, "[i]n contrast, employees who move from State government employment to a job with a local township, county, or municipality, or visa versa, would be considered to be newly hired." Muhlenberg, at 373 (emphasis added.) The Code, Revenue Rulings 86-88 and 88-36, legislative history, and the analysis by the court in Muhlenberg all establish that when an employee transfers to a state employer from a political subdivision employer, or visa versa, the employee's employment relationship with the political subdivision is terminated, and the employee begins performing services for a different entity. Thus, the continuing employment exception is not applicable to the facts of this case.

You also refer to the Muhlenberg court's analogy to the "same desk rule," which provides generally that employees who continue on the same job for a different employer as a result of a liquidation, merger or consolidation of the former employer are not considered separated from employment for purposes of determining whether a lump sum distribution from an exempt employees' trust is made on account of an employee's separation from service within the meaning of Code § 402(e)(4)(D) (retirement plan rules). In contrast to the facts in Muhlenberg, the facts in the instant case are clearly addressed under the plain language of the Code, which specifies that a state and a political subdivision are two distinctly separate employers. *See* Code § 3121(u)(2)(D)(ii). Thus, we see no need to look to other statutes that may be analogous to resolve an issue that is unambiguously answered in Code §

3121(u)(2)(D).[1]

Conclusion

After careful reconsideration of the issues presented and positions advocated in your ruling request, as well as a thorough review of State X's original request, we conclude that the original determination was warranted by the facts and circumstances of the case. No new facts, law, or legal arguments cause us to change or alter the conclusion we reached in the original ruling. Accordingly, we affirm our prior ruling, concluding that the employees of Political Subdivision 1 ceased to be eligible for the continuing employment exception following their transfer to employment with State X. We further rule that employees of Political Subdivisions 2-7 who were transferred to employment with State X are not eligible for the continuing employment exception.

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.

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.

Sincerely,

Lynne Camillo
Chief, Employment Tax Branch 2
Office of Assistant Chief Counsel
(Exempt Organizations/Employment
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[1] Moreover, we note that the applicability of retirement plan provisions to resolve the employment tax issue presented in your ruling request is tenuous at best. *See, e.g.,* Wulf v. Quantum Chem. Corp., 26 F.3d 1368 (6th Cir. 1994) (Sixth Circuit refused to apply its holding in Muhlenberg to a case brought under the Employee Retirement Income Security Act.)