Internal Revenue Service

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January 23, 2007

Legend

School District A =

School District B =

School District C =

School District D =

New School District X =

New School District Y =

New School District Z =

Type E employees =

Type F employees =

Type G employees =

Date 1 =

Date 2 =

Date 3 =

Dear :

This is in response to your request dated September 21, 2006, supplemented by letter containing additional information dated December 5, 2006, for a letter ruling concerning the applicability of the exemption from Medicare tax contained in section 3121(u)(2)(C) of the Internal Revenue Code (the Code) to certain school district employees following the unification of an elementary school district with a portion of a high school district, which subsequently formed a new unified school district.

FACTS

School District A is a high school district and School Districts B, C, and D were elementary school districts. The children from School Districts B, C, and D attended School District A for junior high and high school. In a referendum held on Date 1, the electorate approved of the creation of New School Districts X, Y, and Z. The creation of the New School Districts X, Y, and Z took effect on Date 2.

New School Districts X, Y, and Z were unified school districts, which resulted from portions of School District A unifying with each of School Districts B, C, and D. Thus, New School Districts X, Y, and Z each spanned a geographic territory equivalent to the pre-referendum School Districts B, C, and D, respectively. However, the portion of School District A territory, which laid outside the geographic territories of New School Districts X, Y, and Z, still provided junior high and high school educational services for such territory following unification. Thus, School District A remained a separate, albeit reduced in size, high school district following the referendum. The present ruling involves the creation of New School District X from the unification of School District B and the portion of School District A that laid within School District B's geographic territory.

New School District X continued to employ the employees of School Districts A and B. Following the referendum on Date 1, employees for School District B were required to be employed with New School District X. The employment results potentially varied with respect to those previously employed with School District A; depending upon whether the employees were Type E, F, or G employees.

Type E employees, who previously worked for a School District A junior high or high school within the former School District B's geographic territory, were required to be

employed with New School District X, the District in which their schools were located following the unification. Type F employees, who previously worked for a School District A junior high or high school within the former School District B's geographic territory, were entitled to retain the same position at the same location, which was within New School District X's boundaries following the unification, or take a different assignment with School District A. Type F employees had until Date 3 to decide whether to retain their same positions within New School District X, or to take new assignments with School District A. If a Type F employee failed to affirmatively elect to take a new position within School District A by Date 3, then such employee was required to be employed with New School District X in the same position that they held prior to the unification.

Type G employees were School District A employees, who worked in more than one territory (besides the New School District X territory) prior to the referendum on Date 1. For example, a Type G employee may have also worked in a territory that would later become New School District Y, New School District Z, or the portion of School District A not subject to the referendum on Date 1, prior to the referendum. Type G employees were permitted to choose, which school district they wanted to work for prior to the start of the next school year. You have represented that New School District X employed a number of Type G employees. You have additionally represented that the Type G employees' wages are not subject to the Medicare exemption under Code section 3121(u)(2)(C). Thus, the present ruling involves only Type E, Type F, and employees previously employed with School District B ("the subject employees").

Among the subject employees were those who were employed prior to April 1, 1986, and who have been continuously employed, performing regular and substantial services, since that date. Following the unification, the subject employees of New School District X, who were previously employed by School Districts A and B were treated as having been continuously employed, and as having the same status after the unification as they had before the unification. As a result, after the unification such subject employees retained their pre-unification seniority, tenure, benefits, and other attributes of employment. You have represented that all subject employees are currently members of a "retirement system" within the meaning of Code section 3121(b)(7)(F).

You request that we rule that the subject employees of New School District X, who were hired by District A or B before April 1, 1986, and who before unification were eligible for the continuing employment exception under Code section 3121(u)(2)(C), will continue to be eligible for the exception following unification.

LAW AND ANALYSIS

Taxes under the Federal Insurance Contributions Act (FICA) consist of an old-age, survivors, and disability (OASDI) portion and a hospital insurance (Medicare) portion.

FICA taxes are computed as a percentage of "wages" paid by the employer with respect to "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment."

Section 3121(b)(7)(F) of the Code generally expands the definition of employment for FICA purposes to include service performed after July 1, 1991, by an employee of a state or local government entity unless the employee is a member of a qualified retirement system.

Section 3121(u) provides that with respect to state and local government employment, Medicare taxes shall be applied without regard to whether the employee is a member of a qualified retirement system. However, section 3121(u)(2)(C) provides an exception to Medicare coverage for services performed by state or local government employees hired before April 1, 1986, provided that such employees were performing regular and substantial services for pay before that date, were employed in good faith before that date, had been hired for purposes other than avoiding the Medicare taxes, and have not at any time on or after that date experienced a termination of the employment relationship with the employer. This is termed the "continuing employment exception."

Rev. Rul. 86-88, 1986-2 C.B. 172, states the Service's position concerning the continuing employment exception and the applicability of the Medicare tax. Rev. Rul. 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, city, town, village, or school district. Under this definition, if an employee simply ceased to work for one school district and began to work for another, he or she would have transferred from one political subdivision employer to another political subdivision employer.

However, 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 entities. Under this case, a consolidated school district formed when three formerly independent school districts merged into one is not a new employer for purposes of the continuing employment exception. The court turned to the legislative history to determine that the purpose of Code section 3121(u)(2)(C) was to protect state and local government entities 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 consolidation of the three

school districts did not create a new employer, and therefore those employees who were eligible for the continuing employment exception to Medicare prior to the consolidation, retained such eligibility as they in substance worked continuously for the same employer, but under a different name.

We conclude that the unification of School Districts A and B, which was authorized by popular referendum, does not give rise to a new employer with respect to the subject employees. This conclusion is consistent with Board of Education of Muhlenberg County. Therefore, for purposes of Code section 3121(u)(2)(C), New School District will not be treated as a new employer. Accordingly, we rule that the subject employees of New School District X, who were hired by District A or B on or before March 31, 1986, and who before unification were eligible for the continuing employment exception, continue to be eligible for the continuing employment exception under section 3121(u)(2)(C) following the unification of the districts.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Code.

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.

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
Branch Chief, Employment Tax Branch 2 (Exempt Organizations/Employment Tax/Government Entities)
(Tax Exempt & Government Entities)