



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:EBEO:Br2

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL,

FROM: Jerry E. Holmes
Chief, Branch 2 (EBEO) CC:EBEO:BR2

SUBJECT: Employment Tax Claim for

This Field Service Advice responds to your memorandum dated February 8, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:
Taxpayer =

X =
Y =

ISSUE(S):

- (1) Do the transition rules of the Proposed Regulations under section 3121(v)(2) of the Internal Revenue Code apply to Taxpayer's claims for refund?
- (2) Do Taxpayer's claims for refund, filed under section 3121(v)(2) after the publication date but before the effective date of the Proposed Regulations, satisfy the requirements for a "good faith, reasonable interpretation"?
- (3) Should Taxpayer's claims for refund treating severance pay as nonqualified deferred compensation under section 3121(v)(2) for years preceding the effective date of the proposed regulations be granted?

CONCLUSION:

- (1) The transition rules of the Final Regulations under section 3121(v)(2), published January 29, 1999, are generally applicable to Taxpayer's claims for refund.
- (2) Taxpayer's claims for refund, filed after the publication of the Proposed Regulations but before the effective date of the Final Regulations, do not appear to satisfy the reasonable, good faith requirement of the Final Regulations because (a) Taxpayer's original action is in accordance with the Final Regulations; (b) Taxpayer's amended action would not be in accordance with the Final Regulations; and (c) section 31.3121(v)(2)-1(g)(2)(iii), providing that such treatment of stock options is not in accordance with a reasonable, good faith interpretation, is analogous.
- (3) Taxpayer's claims for refund treating severance pay as nonqualified deferred compensation under section 3121(v)(2) for years preceding the effective date of the Final Regulations should not be granted.

FACTS:

Taxpayer made severance payments¹ to certain terminated employees in
 The recipient employees were either involuntarily terminated or terminated after refusing a transfer. Each severance payment equaled the recipient employee's weekly salary. The duration of the payments depended on the employee's length of service with Taxpayer. Some employees received payments over two calendar years.

Taxpayer originally treated the severance payments as subject to Federal Insurance Contributions Act (FICA) tax when paid to an employee in

Taxpayer subsequently filed a claim for refund for such taxes, alleging that the payments could have been treated as subject to FICA tax when an employee's severance benefit was determined and awarded in

Taxpayer conditionally deposited an additional sum of \$X with the Internal Revenue Service for the additional taxes due for the years , simultaneously requesting a refund of \$Y for the years

LAW AND ANALYSISBackground

¹ We do not have enough information to verify that the payments were severance pay within the meaning of section 31.3121(v)(2)-1(b)(4)(iv)(B) of the Final Regulations. This Field Service Advice assumes that the classification as severance pay is correct.

Wages are generally subject to FICA tax when they are actually or constructively paid. Section 31.3121(a)-2(a) of the regulations. Section 3121(v)(2) of the Code was enacted as a special timing rule as part of the 1983 Amendments when Congress repealed the general retirement FICA tax exclusions provided in section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Section 3121(v)(2)(A) provides that any amount deferred under a nonqualified deferred compensation plan shall be taken into account as wages for purposes of the FICA tax as of the later of (i) when the services are performed, or (ii) when there is no substantial risk of forfeiture of the rights to such amount. The term "nonqualified deferred compensation plan" means any plan or other arrangement for deferral of compensation other than a plan described in section 3121(a)(5), which generally refers to qualified retirement plans and tax-favored annuities. Section 3121(v)(2)(C). Any amount taken into account as wages by reason of 3121(v)(2)(A) (and the income attributable thereto) shall not thereafter be treated as wages for FICA tax purposes. Section 3121(v)(2)(B).²

Consequently, section 3121(v)(2) generally accelerates the FICA tax timing of deferred compensation to the time of deferral so that no FICA tax is due with respect to the principal or the income when it is actually or constructively paid to the recipient.

In Notice 94-96, 1994-2 C.B. 564, the Service announced its intention to publish guidance under section 3121(v)(2) and stated that the effective date of the proposed regulations will not be before January 1, 1995. Thus, the Service announced, it will not challenge an employer's determination of FICA tax liability with respect to a nonqualified deferred compensation plan for periods preceding the effective date, if the employer's determination is based on a reasonable, good faith interpretation of section 3121(v)(2).

The Service published Proposed Regulations under section 3121(v)(2) on January 25, 1996, in a Notice of Proposed Rulemaking, reprinted at 1996-1 C.B. 743. Section 31.3121(v)(2)-1(g) of the Proposed Regulations provides that the regulations are effective for amounts deferred and benefits paid after January 1, 1997. The proposed effective date was subsequently amended to January 1, 1998. Notice of Proposed Rulemaking, reprinted at 1998-8 I.R.B. 40. Final Regulations under section 3121(v)(2) were published January 29, 1999, applicable on or after January 1, 2000.³

² Section 3306(r)(2) applies for FUTA tax purposes and is identical to section 3121(v)(2). The application of section 3306(r)(2), however, is not at issue in your request for field service advice.

³ Section 31.3121(v)(2)-1(g)(1) provides that paragraphs (a) through (f) of the section apply to amounts deferred on or after January 1, 2000; to amounts deferred before January 1, 2000, which cease to be subject to a substantial risk of forfeiture on or after January 1, 2000, or for which a resolution date occurs on or after January 1,

T.D. 8814, 1999-9 I.R.B. 4. Subsection (g) of the Final Regulations provides transition rules for amounts deferred and benefits paid before January 1, 2000, and generally requires that the employer acted in accordance with a reasonable, good faith interpretation of section 3121(v)(2).

Taxpayer's claims for refund will be analyzed herein under the authority of the Final Regulations, including the transition rules contained therein, except to the extent the Proposed Regulations are applicable for determining whether Taxpayer acted in accordance with a reasonable, good faith interpretation of section 3121(v)(2). Hence, unless noted otherwise, all references are to the Final Regulations.

Deferred Compensation

As discussed above, Congress enacted section 3121(v)(2) as a special FICA tax timing rule for nonqualified deferred compensation at the same time it repealed the FICA tax exclusions for nonqualified retirement benefits formerly contained in section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii). Section 31.3121(v)(2)-1(a)(2) of the Employment Tax Regulations reiterates the special timing rule for amounts deferred under a nonqualified deferred compensation plan. Section 31.3121(v)(2)-1(b)(1) defines the term "nonqualified deferred compensation plan" as any plan or other arrangement, other than a plan described in section 3121(a)(5), that is established (within the meaning of paragraph (b)(2)) by an employer for one or more of its employees, and that provides for the deferral of compensation (within the meaning of paragraph (b)(3)). A plan provides for the "deferral of compensation" with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable in a later year. Section 31.3121(v)(2)-1(b)(3).

Nonetheless, section 31.3121(v)(2)-1(b)(4)(iv)(A) provides that severance pay, among other things, does not result from the deferral of compensation for purposes of section 3121(v)(2). The Final Regulations amended the Proposed Regulations by clarifying what constitutes severance pay for purposes of this section. See section 31.3121(v)(2)-1(b)(4)(iv)(B). If classification of the payments at issue as severance pay is correct,⁴ Taxpayer's payments are not subject to the special timing rule of section 3121(v)(2) under the Proposed or Final Regulations. Consequently, Taxpayer's original FICA tax treatment of the severance payments, i.e., subjecting them to FICA tax upon payment, is in accordance with both the Proposed and Final regulations.

Transition Rules

2000; and to benefits actually or constructively paid on or after January 1, 2000.

⁴ See supra note 1.

Since Taxpayer's payments represent amounts deferred and benefits paid before January 1, 2000, however, the relevant inquiry becomes how the transition rules under the Final Regulations apply to the payments. More specifically, the issue becomes whether Taxpayer's original FICA tax treatment is, and whether Taxpayer's amended FICA tax treatment, via filing claims for refund, would be, in accordance with a reasonable, good faith interpretation of section 3121(v)(2) for purposes of the transition rules.

Section 31.3121(v)(2)-1(g)(2) provides that, for periods before January 1, 2000 (including amounts deferred before January 1, 2000, and any benefits actually or constructively paid before January 1, 2000, that are attributable to those amounts deferred), an employer may rely on a reasonable, good faith interpretation of section 3121(v)(2), taking into account pre-existing guidance.⁵ An employer will be deemed to have determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has complied with paragraphs (a) through (f) of the regulations. For purposes of the transition rules of paragraphs (g)(2) through (4), and subject to paragraphs (g)(2)(ii) and (iii), whether an employer that has not complied with paragraphs (a) through (f) has determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) will be determined based on the relevant facts and circumstances, including consistency of treatment by the employer and the extent to which the employer has resolved unclear issues in its favor.

Section 31.3121(v)(2)-1(g) provides a number of specific transition rules. The transition rule in paragraph (g)(3)(i) applies if an employer determined FICA tax liability with respect to section 3121(v)(2) in any period ending prior to January 1, 2000, for which the applicable period of limitations has not expired on January 1, 2000, in a manner that was not in accordance with the regulations, and permits the employer to adjust its FICA tax determination for that period to conform with the regulations. However, paragraph (g)(3)(ii) permits a claim for refund or credit for FICA tax paid only

⁵ We are not aware of any guidance that concludes that compensation similar to Taxpayer's severance payments is subject to section 3121(v)(2). Furthermore, we are not aware of any guidance that treated such compensation as excludable from wages for FICA tax purposes under the retirement exclusions in former section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii), which were eliminated in connection with enacting the special timing rule for including the newly taxable benefits for FICA tax purposes. Conversely, in PLR 9326007 the Service concluded that, since the benefits at issue were "in the nature of termination pay, or severance pay," and would be paid only in certain circumstances related to the acquisition of the employer, the benefits were not deferred compensation for purposes of section 3121(v)(2). Prior to the enactment of section 3121(v)(2), the Service had concluded that severance pay was not excludable from wages under section 3121(a)(2)(A), (a)(3), or (a)(13)(A)(iii). See PLR 8344037.

to the extent it exceeds the FICA tax that would have been due had the employer determined FICA tax liability in accordance with the regulations.

Paragraph (g)(3)(iii) provides an additional explicit limitation with respect to an employer's FICA tax treatment of stock options or similar items. Specifically, in the case of a stock option, stock appreciation right, or other stock value right (as defined in paragraph (b)(4)(ii)) that is exercised before January 1, 2000, an employer that treats the exercise as not subject to FICA tax as a result of the nonduplication rule of section 3121(v)(2)(B) is not acting in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer has not treated that grant and all earlier grants as subject to section 3121(v)(2) by reporting the current value of such options and rights as FICA wages on Form 941 filed for the quarter during which each grant was made (or, if later, for the quarter during which each grant ceased to be subject to a substantial risk of forfeiture). In other words, stock options are subject to FICA tax on exercise, in accordance with the general timing rule, unless the employer originally treated all stock options as subject to FICA tax upon grant (or cessation of the substantial risk of forfeiture) under 3121(v)(2). This rule was added by the Final Regulations.

Paragraph (g)(4) applies the reasonable, good faith interpretation standard. The transition rule in paragraph (g)(4)(i) concerns plans that are not subject to section 3121(v)(2) but for which, for a period ending prior to January 1, 2000, and, pursuant to a reasonable, good faith interpretation of section 3121(v)(2), an employer took an amount into account as an amount deferred under a nonqualified deferred compensation plan.⁶ If paragraph (g)(4)(i) applies, (A) no additional FICA tax is due on benefit payments made before January 1, 2000, that are attributable to amounts previously taken into account; (B) benefit payments made after January 1, 2000, are subject to FICA tax when paid; and (C) the employer can get a refund, subject to the applicable period of limitations and the limitations of paragraph (g)(3), for FICA tax paid on amounts taken into account prior to January 1, 2000.

Analysis

As discussed above, Taxpayer's severance payments do not result from the deferral of compensation for purposes of section 3121(v)(2) under the Proposed or Final regulations. Consequently, Taxpayer's original action of treating the payments as FICA wages at the time of payment is in accordance with the Proposed and Final regulations and, thus, deemed to be pursuant to a reasonable, good faith interpretation under section 31.3121(v)(2)-1(g)(2) of the Final Regulations.

⁶ The transition rules in paragraphs (g)(4)(ii) and (iii) are not relevant since they apply to plans that are subject to section 3121(v)(2) for which the employer took less or more, respectively, than the amount deferred into account.

Taxpayer's amended action, via filing claims for refund, of treating the severance benefits as subject to section 3121(v)(2) and taxing the benefit at the time of deferral (i.e., when the employee terminated), however, would not be in accordance with the Proposed or Final regulations. Nor would Taxpayer's amended action appear to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) under the facts and circumstances test of section 31.3121(v)(2)-1(g)(2) for the following reasons: (1) At the time Taxpayer filed its claims for refund, the Proposed Regulations had been published, stating that severance pay was not subject to section 3121(v)(2); to rely on the opposite position after the publication of the Proposed Regulations and in reliance upon the transition rules of the Proposed Regulations would not appear to be a reasonable interpretation;⁷ (2) Taxpayer had originally interpreted section 3121(v)(2) as not applicable to the benefits at issue; to rely on the opposite interpretation after the publication of the Proposed Regulations and in reliance upon the transition rules of the Proposed Regulations would not appear to be in good faith;⁸ (3) no other "pre-existing guidance" treated compensation similar to Taxpayer's severance payments as subject to section 3121(v)(2) or as excludable from FICA wages under former section 3121(a)(2)(A), (a)(3), or (a)(13)(A)(iii);⁹ and (4) the limitation provided in paragraph (g)(2)(iii) with respect to an employer's treatment of stock options is significantly analogous to Taxpayer's amended action so that no reasonable, good faith interpretation arguably exists where Taxpayer treats the severance payments as subject to section 3121(v)(2) at a time other than when Taxpayer filed Forms 941 for the quarters when the employees terminated. Therefore, we do not believe Taxpayer could rely on its amended action under the transition rule in section 31.3121(v)(2)-1(g)(2).

Since Taxpayer's original action is in accordance with a reasonable, good faith interpretation, Taxpayer may rely on such action under paragraph (g)(2). Since Taxpayer's original action is in accordance with the Final Regulations, no optional adjustment is needed or permitted under paragraph (g)(3). Furthermore, any optional adjustment would be subject to the limitation in paragraph (g)(3)(ii) which provides that an employer may not obtain a refund if doing so will result in the employer paying less FICA taxes than if the regulations applied to the amounts at issue, thus, eliminating any refund to Taxpayer. Since Taxpayer's amended action would not appear to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2), as discussed above, the specific transition rule of paragraph (g)(4)(i) does not appear to apply. For these reasons, we believe that the claims for refund should not be granted.

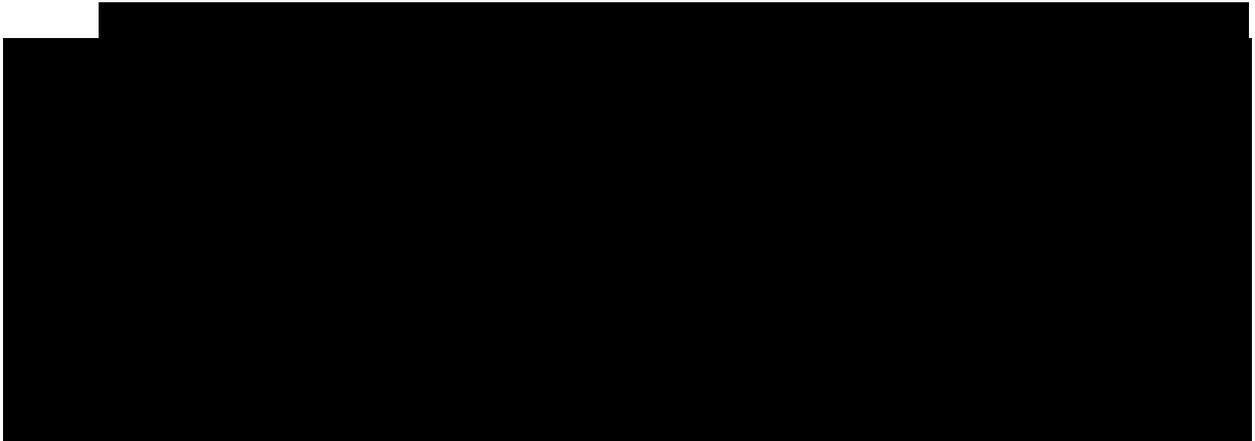
⁷ The existence of PLR 9326007 further argues against finding Taxpayer's amended action to be in accordance with a reasonable, good faith interpretation, notwithstanding the ruling's lack of precedential value. See supra note 5.

⁸ See supra note 7.

⁹ See supra note 5.

Taxpayer's citation to Hoerl & Associates v. United States, 996 F.2d 226 (10th Cir. 1993), and Buffalo Bills, Inc. v. United States, 31 Fed. Cl. 794 (1994), does not change our conclusion. Both cases involve materially different facts, both opinions were issued prior to the publication of the Proposed Regulations, and Taxpayer did not rely on the cases in determining its FICA tax liability with respect to the severance payments.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



¹⁰ [Redacted]

[Redacted]

¹¹ In applying these rules, we do not believe Taxpayer's claims for refund satisfy the explicit requirement for a reasonable, good faith interpretation for all the reasons discussed in the above section.

¹⁰ [Redacted]

¹¹ [Redacted]

[REDACTED]

[REDACTED]

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[REDACTED] we believe that the stronger technical argument calls for disallowing the claims for refund on the basis that Taxpayer's original treatment of the severance pay is correct under the Final Regulations and Taxpayer's amended treatment would be neither correct nor in accordance with a reasonable, good faith interpretation of section 3121(v)(2). The primary arguments against this conclusion are faulty for the reasons discussed herein.

[REDACTED]

If the classification of Taxpayer's benefit as severance pay within the meaning of the Final Regulations is correct, we see no factual deficiencies in this case to support granting Taxpayer's claims for refund.

12 [REDACTED]

If you have any further questions, please call (202) 622-6040.

Jerry E. Holmes
Chief, Branch 2 (EBEO)

By: _____
JERRY E. HOLMES
Chief, Branch 2
Associate Chief Counsel (Employee
Benefits & Exempt Organizations)