OFFICE OF
CHIEF COUNSEL

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

July 9, 1999

Number: **199947003**
Release Date: 11/26/1999
CC:EBEO:Br2
WTA-N-108181-99

UILC: 3121.01-12

INTERNAL REVENUE SERVICE NATIONAL OFFICE
WRITTEN TECHNICAL ASSISTANCE

MEMORANDUM FOR
Employment Tax Specialist

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

SUBJECT: Employment Tax Claim for

This Technical Assistance responds to your memorandum dated April 5, 1999. National Office Technical Assistance 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 =

Year A =
Year B =
Year C =
Year D =

Date 1 =
Date 2 =

ISSUES:

(1) Do Taxpayer=s claims for refund with respect to amounts paid under its severance plan, stock option plan, and Performance Unit Plan, filed under section 3121(v)(2) after the publication date of the Proposed Regulations but before the effective date of the Final Regulations, satisfy the requirements for a Areasonable, good faith interpretation@ of section 3121(v)(2)?

(2) Should Taxpayer=s claims for refund, treating amounts paid under its severance plan, stock option plan, and Performance Unit Plans as nonqualified deferred compensation under section 3121(v)(2) for years preceding the effective date of the Final Regulations, be granted?

CONCLUSIONS:

(1) Taxpayer=s claims for refund with respect to amounts paid under its severance plan and stock option plan, filed after the publication of the Proposed Regulations but before the effective date of the Final Regulations, do not 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 of section 3121(v)(2), is analogous.

Taxpayer=s claims for refund with respect to its Performance Unit Plan, filed after the publication of the Proposed Regulations but before the effective date of the Final Regulations, appear to satisfy the reasonable, good faith requirement of the Final Regulations because Taxpayer=s original action is not in accordance with the Final Regulations, and Taxpayer=s amended action would be in accordance with the Final Regulations.

(2) Taxpayer=s claims for refund treating amounts paid under its severance plan and stock option plan as nonqualified deferred compensation under section 3121(v)(2) for years preceding the effective date of the Final Regulations should be denied. Taxpayer=s claims for refund treating amounts paid under its Performance Unit Plan as nonqualified deferred compensation under section 3121(v)(2) for years preceding the effective date of the Final Regulations should be allowed.

FACTS:

1. Severance Plan:

On Date 1, Taxpayer adopted a severance plan for regular salaried and hourly employees who lose their positions with the company. Taxpayer states that the plan

provides for severance payments to eligible employees who are involuntarily terminated due to a change in operations, a facility relocation or closing, a reduction in force for other economic reasons, a sale or merger of all or part of the company=s business or assets where the employee is not offered continued employment, or certain other forms of corporate reorganization.[1] The severance plan is unfunded. Benefit payments are made from the Taxpayer=s general assets.

The amount of severance benefits paid after termination of service is at the sole discretion of the company, but generally is based upon the employee=s length of service and pre-termination pay. Some employees received a lump sum severance payment, others were placed on a paid @leave of absence@ period, depending on the employee=s length of service with Taxpayer, not to exceed 24 months. Those severance payments made in the year(s) after termination are the subject of the Taxpayer=s refund claim.

Taxpayer made severance payments in Years A, B, C, and D to certain terminated employees. Taxpayer originally treated the severance payments as subject to Federal Insurance Contributions Act (FICA) taxes[2] and Federal Unemployment Tax Act (FUTA) taxes in the year that the severance pay was paid to an employee. Taxpayer subsequently filed a claim for refund for such taxes, alleging that the payments should have been treated as subject to FICA and FUTA taxes when an employee=s severance benefit was determined. Taxpayer conditionally deposited additional amounts with the Internal Revenue Service and/or offset its refund requests for any additional taxes due for those

---

[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 Technical Assistance assumes that the classification as severance pay is correct. Taxpayer asserts that since Date 2, which pre-dates Date 1, employees who voluntarily separated from service under certain conditions were also eligible for severance payments. However, the conditions under which such voluntary separation gave rise to severance pay were not provided. Furthermore, Taxpayer=s submission refers to employees Abeing notified of the impending separation from service@ and employees Areceiving notification of termination of service,@ indicating that employees did not voluntarily terminate.

[2] FICA taxes consist of Old Age, Survivors, and Disability Insurance (OASDI) tax, and Hospital Insurance (HI) tax. Section 3121(a)(1) imposes a dollar limit on the annual amount of wages subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on the annual amount of wages subject to the HI portion of FICA tax, effective for 1994 and later years. Section 3306(b)(1) imposes a dollar limit on the annual amount of wages subject to FUTA tax.

employees who did not exceed the OASDI and/or HI wage base(s) in the respective years of notification of termination. Subject to that offset, Taxpayer claims a refund on the balance of the FICA taxes paid. Under the same theory, Taxpayer also claims a refund of FUTA tax paid.

2. Stock Option Plan:

Taxpayer maintains three nonqualified stock option plans under which employees exercised options in Years A through D. Taxpayer withheld and paid FICA tax and paid FUTA tax, subject to the applicable wage base limitations, with respect to the income received from the exercise of the options in each of those years. In its claim for refund, Taxpayer asserts that an employee=s income from the exercise of stock options is deferred from the date the option vested (when the option was no longer subject to a substantial risk of forfeiture and no further services were required of the employee in order to be able to exercise the option). Therefore, Taxpayer asserts that the FICA and FUTA taxes were due when the options vested and has filed amended returns in accordance with such treatment. Accordingly, Taxpayer conditionally deposited additional amounts with the Internal Revenue Service and/or offset its refund requests for any additional taxes due for those employees who did not exceed the OASDI and/or HI wage base(s) in the respective years of the vesting of the options. Subject to that offset, Taxpayer claims a refund on the balance of the FICA and FUTA taxes paid. Taxpayer also claims a refund of FUTA tax paid upon exercise under the same theory.

3. Performance Unit Plan:

Taxpayer also maintained a Performance Unit Plan (PUP) during the years in issue which Taxpayer describes as a combination of a phantom stock and a performance incentive plan. Under the plan, performance units were granted to selected employees who also received nonqualified stock options, in amounts corresponding to the number of shares covered by the options. The performance units vested three years after grant, contingent upon the attainment of certain Taxpayer performance goals, which are based upon earnings per share and return on equity. Once the performance units vested, the PUP accounts were valued based upon the value of Taxpayer stock as of that date. After vesting, the PUP accounts earned interest at a rate not to exceed 2/3 of the Taxpayer=s return on average capital structure, defined as after-tax earnings and after-tax interest expense, divided by average capital structure.

The PUP account withdrawal rules provide that the amount in each employee=s PUP account may be withdrawn at any time, but only if the employee forfeited nonqualified stock options corresponding to the number of performance units granted when the option was granted. Similarly, when an employee exercised any stock options corresponding to his or

her PUP account shares, that employee=s PUP account was decreased by the number of PUP account shares corresponding to the number of options.

Distributions from the PUP account were made in Year A and Year C. Taxpayer withheld and paid FICA taxes, subject to the applicable wage base limitation, when distributions from the PUP accounts were made. In its claim for refund, Taxpayer asserts that an employee=s income from the PUP account distributions is deferred from the date the PUP account vested, at the end of the three year period after the performance unit was granted. Therefore, Taxpayer asserts, the FICA tax was due at that time. Accordingly, Taxpayer conditionally deposited additional amounts with the Internal Revenue Service and/or offset its refund requests for any additional taxes due for those employees who did not exceed the OASDI and/or HI wage base(s) in the respective years of the vesting of the PUP accounts. Subject to that offset, Taxpayer claims a refund on the balance of the FICA taxes paid. No FUTA taxes are in controversy with respect to the Performance Unit Plan.

LAW AND ANALYSIS

Background

Wages are generally subject to FICA tax when they are actually or constructively paid. Employment Tax Regulation section 31.3121(a)-2(a). 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).[3]

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 received by the recipient.

---

[3] Section 3306(r)(2) applies for FUTA tax purposes and is identical to section 3121(v)(2). The regulations under section 3306(r)(2) cross-reference the regulations under section 3121(v)(2).

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. That 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.[4] 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 below under the authority of the Final Regulations, including the transition rules contained in those Final Regulations, except to the extent the Proposed Regulations apply to determine 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 Anonqualified deferred compensation plan@ as any plan or other arrangement, other than a plan described in section 3121(a)(5), that is established by an employer for one or more of

[4] 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, 2000; and to benefits actually or constructively paid on or after January 1, 2000.

its employees, and that provides for the deferral of compensation. A plan provides for the Adeferral 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, 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.

Similarly, section 31.3121(v)(2)-1(b)(4)(ii) provides that the grant of a stock option, stock appreciation right, or other stock value right does not constitute the deferral of compensation for purposes of section 3121(v)(2). The Final Regulations amended the Proposed Regulations by clarifying that amounts received as a result of the exercise of a stock option, stock appreciation right, or other stock value right do not result from the deferral of compensation for purposes of section 3121(v)(2) if such amounts are actually or constructively received in the calendar year of the exercise. See section 31.3121(v)(2)-1(b)(4)(iv)(B). Taxpayer=s grant of stock options is 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 stock options, i.e., subjecting them to FICA tax upon exercise, is in accordance with both the Proposed and Final regulations, as well as other published guidance. See Rev. Rul. 67-257, 1967-2 C.B. 359.

However, section 31.3121(v)(2)-1(b)(4)(ii) further provides that the term stock value right does not include a phantom stock or other arrangement under which an employee is awarded the right to receive a fixed payment equal to the value of a specified number of shares of employer stock. Taxpayer=s Performance Unit Plan appears to be such a phantom stock arrangement and is therefore subject to the special timing rule set forth in section 3121(v)(2). Consequently, Taxpayer=s amended FICA tax treatment of the amounts paid under the PUP accounts, i.e., subjecting them to FICA tax upon vesting, is in accordance with both the Proposed and Final regulations.

Transition Rules

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. 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 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 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).

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. 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.

Finally, the transition rules in paragraphs (g)(4)(ii) apply to plans that are subject to section 3121(v)(2) for which the employer, in accordance with a reasonable, good faith interpretation of section 3121(v)(2), either took into account an amount that is less than the amount that would have been required to be taken into account if paragraphs (a) through (f) of the Final Regulations had been in effect for that period or took no amount into account. Section 31.3121(v)(2)-1(g)(4)(ii)(B) provides that if an employer took less than the amount deferred into account, or took no amount into account, no additional FICA tax will be due for any period ending prior to January 1, 2000. Section 31.3121(v)(2)-1(g)(4)(ii)(B) provides that the general timing rule described in paragraph 31.3121(v)(2)-1(a)(1) applies to benefits actually or constructively paid on or after January 1, 2000, attributable to an amount deferred in a period before January 1, 2000, to the extent the amount taken into account was less than the amount that would have been required to be taken into account if paragraphs (a) through (f) of the Final Regulations had been in effect before January 1, 2000.

However, section 31.3121(v)(2)-1(g)(3) provides that if an employer determined FICA tax liability with respect to section 3121(v)(2) in any period ending before January 1, 2000, for which the applicable period of limitations has not expired on January 1, 2000 (pre-effective-date open periods), in a manner that was not in accordance with the Final Regulations, the employer may, subject to the consistency requirement set forth in paragraph (g)(3)(ii), adjust its FICA tax determination for that period to conform to the Final Regulations. Thus, if an amount deferred was taken into account in a pre-effective-date open period when it was not required to be taken into account (e.g., an amount taken into account before it became reasonably ascertainable), the employer may claim a refund or credit for any FICA tax paid on that amount to the extent permitted by sections 6402, 6413, and 6511. Similarly, paragraph (g)(3) permits an employer to take into account an amount deferred that was not taken into account during any pre-effective date open periods in accordance with the reporting requirements set forth in paragraph (g)(3)(iii).

Analysis **B** Severance Plan

As discussed above, amounts paid under Taxpayer=s severance plan 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.

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 be a reasonable interpretation;(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; (3) no other Apre-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).[5]; 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

[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 Ain 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.

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 of section 3121(v)(2), 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). Since Taxpayer=s amended action with respect to the severance payments would not 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 apply. For these reasons, we believe that the claims for refund with respect to those payments should be denied.

Taxpayer asserts an alternative argument that the severance payments are not wages for purposes of FICA and FUTA taxation[6] under two separate theories. First, Taxpayer argues that the payments compensate not for services performed, but for agreements releasing the Taxpayer from potential claims by terminated employees. The agreements release Taxpayer from claims made under Federal, state and local laws prohibiting employment discrimination, including discrimination on the basis of age, sex, race, or handicap, and from claims made under a tort or tort-like theory, which Taxpayer elaborates would be Aemotional distress.@ The second theory that Taxpayer asserts provides a basis for concluding that the severance payments are not wages for purposes of FICA and FUTA taxation is that the severance was not paid for services, but was paid because the employees agreed to stop performing services. Service position is well established on these issues and thus they are discussed very briefly in this memorandum.

Section 31.3401(a)-1(b)(4) of the regulations provides that "any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments."[7] Dismissal payments

---

[6] Sections 3121(a) and 3306(b) define wages, for purposes of FICA and FUTA, respectively, as Aall remuneration for employment.@ Those sections go on to provide that employment is services performed by an employee for the person employing him.

[7] Although the foregoing section pertains to wages for income tax withholding purposes, the Social Security Act Amendments of 1950 extend the reach of the definition so that such payments constitute wages under FICA and FUTA. See Rev. Rul. 71-408, 1971-2 C.B. 340.

are deemed to be made in recognition of past services and are wages subject to employment taxes. Similarly, Revenue Ruling 73-166, 1973-1 C.B. 411, holds that payments made to involuntarily terminated workers who agreed not to pursue any action against the company are wages subject to FICA, FUTA and income tax withholding.

Taxpayer asserts that the severance payments are really payments for the employees= release of future claims against Taxpayer. Taxpayer further asserts that such claims would be tort or tort-like and thus would be excludable from income under section 104(a)(2) and therefore would be excludable from wages for FICA and FUTA purposes. In support of that assertion, Taxpayer cites to Dotson v. United States, 87 F.3d 682, 689 (5th Cir. 1996) (holding that settlements awarded to plaintiffs in a class action suit against Continental Can Co. for interference with the attainment of pension rights under section 502(a)(3) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) are not income or wages); Redfield v. Insurance Co. of No. America, 940 F.2d 542, 548 (9th Cir. 1991) (holding that age discrimination award, consisting of punitive and emotional damages, did not constitute income or wages); and Anderson v. United States, 929 F.2d 648, 654 (Fed. Cir. 1991) (holding that payments for temporary lodging provided under the Overseas Differentials and Allowances Act are not income or wages). However, case law in this area is unsettled. In fact, the Eighth Circuit, in which the instant claim is made, considered the same payments as those in Dotson and held that the payments were income and wages. See Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998) (holding that the settlement payments from Continental Can Co. for interference with the attainment of pension rights under ERISA constitute income and wages). Furthermore, Taxpayer=s payments are clearly distinguishable from the payments that were at issue in each of the cases that Taxpayer cites in support of its argument for exclusion. Additionally, whether payments to terminated employees ostensibly made in consideration of a waiver of such a right constitutes income or wages is even less clear.

We see no facts evidencing that the payments from Taxpayer to its terminated employees are anything other than dismissal payments as described in section 31.3401(a)-1(b)(4) and therefore do not further address Taxpayer=s arguments that the payments are not wages.

Analysis - Stock Option Plan

As discussed above, Taxpayer=s stock option plan does not provide for 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.

Taxpayer=s amended action, via filing claims for refund, of treating the grant of stock options as subject to section 3121(v)(2), 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 stock options do not constitute deferred compensation for purposes of 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;[8] (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; (3) no other Apre-existing guidance@ treated compensation similar to Taxpayer=s option grants 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); and (4) the limitation provided in paragraph (g)(2)(iii) with respect to an employer=s treatment of stock options applies to Taxpayer=s amended action so that no reasonable, good faith interpretation exists where Taxpayer might treat the option grants as subject to section 3121(v)(2) at a time other than when Taxpayer filed Forms 941 for the quarters when grants were made. Therefore, Taxpayer may not 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 of section 3121(v)(2), 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). Since Taxpayer=s amended action with respect to the stock options is not 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 apply. For these reasons, we believe that the claims for refund with respect to those payments should be denied.

Analysis **B** Performance Unit (Phantom Stock) Plan

Taxpayer=s Performance Unit Plan constitutes a phantom stock plan as described in section 31.3121(v)(2)-1(b)(4)(ii) because it is merely an account balance plan that credits interest based upon a formula that reflects corporate performance. Because Taxpayer=s PUP plan is a phantom stock plan (and does not constitute a stock value right, which may

[8] The existence of explicit rules governing stock options in section 83 and the regulations thereunder further argues against finding Taxpayer=s amended action to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2).

not be treated as deferred compensation pursuant to section 31.3121(v)(2)-1(b)(4)(ii)), the vesting of Taxpayer=s PUP account phantom stock constitutes deferral of compensation for purposes of section 3121(v)(2) under the Proposed and Final regulations. Thus, Taxpayer=s original action of treating amounts paid from the PUP accounts as FICA wages at the time of payment is not in accordance with the Proposed and Final regulations. Therefore, Taxpayer may adjust its FICA tax determinations for open periods to conform with the Final Regulations pursuant to section 31.3121(v)(2)-1(g)(3).

That adjustment is permitted subject to the consistency requirement set forth in section 31.3121(v)(2)-1(g)(3)(ii). That section provides that if any benefit payments attributable to amounts deferred after December 31, 1993, were actually or constructively paid to an employee under a nonqualified deferred compensation plan in a pre-effective-date open period, but those payments were treated as subject to FICA tax because the employer treated the plan as not being a nonqualified deferred compensation plan, then the employer may claim a refund or credit for the FICA tax paid on those benefit payments only to the extent that the FICA tax paid on those benefit payments exceeds the FICA tax that would have been due on the amounts deferred to which those benefit payments are attributable if those amounts deferred had been taken into account when they would have been required to have been taken into account under this section (if this section had been in effect then). Accordingly, we believe that Taxpayer=s claims for refund with respect to those payments should be allowed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Taxpayer cites 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), to support a finding that its severance plan should qualify as nonqualified deferred compensation under section 3121(v). However, a review of those cases do 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.

Taxpayer also points to a statement made by James McGovern, former Assistant Chief Counsel (Employee Benefits and Exempt Organizations), before the Subcommittee on Social Security of the House Ways and Means Committee on April 5, 1990,[9] as support for its theory that treating severance pay as subject to section 3121(v)(2) is a reasonable,

---

[9] A ...almost any arrangement might arguably be classified within the scope of section 3121(v)(2). ... At this time it is not clear whether other types of plans and arrangements B (such as welfare benefit programs, stock option arrangements, vacation pay plans, and severance pay plans) will receive section 3121(v)(2) treatment.@

good faith interpretation of the section. Whatever limited relevance such general statement might have in applying the reasonable, good faith interpretation to other facts, such statement has no relevance in this case since Taxpayer did not rely upon it in determining its FICA tax liability prior to the Service publishing the Proposed Regulations.

Additionally, Taxpayer asserts that its severance plan is a window plan within the meaning of section 31.3121(v)(2)-1(b)(4)(v)(B). That section defines a window benefit as an early retirement benefit, retirement-type subsidy, social security supplement, or other form of benefit made available by an employer for a limited period of time (no greater than one year) to employees who terminate employment during that period or to employees who terminate employment during that period under specified circumstances.

Section 31.3121(v)(2)-1(b)(4)(v) provides that, like severance pay, a window benefit is a benefit provided in connection with impending termination of employment that does not result from the deferral of compensation within the meaning of section 3121(v)(2). However, section 31.3121(v)(2)-1(b)(4)(v)(B)(3) of the Final Regulations provides a special transition rule for window benefits that permits an employer to choose to treat a window benefit that is made available for a period of time that begins before January 1, 2000, as a benefit that results from the deferral of compensation if the sole reason the window benefit would otherwise fail to be provided pursuant to a nonqualified deferred compensation plan is because it is a window benefit. That transition rule can be read in combination with the transition rule in paragraph (g)(3) to permit an employer to amend returns with respect to window benefits made available prior to January 1, 2000, treating the window benefits as deferred compensation for any pre-effective date open periods. That adjustment is permitted even though window benefits are not nonqualified deferred compensation under the Final Regulations and may not be treated as such after the effective date of those regulations (January 1, 2000).

We see no evidence of any facts suggesting that Taxpayer=s plan offers a bona fide window benefit. The benefits appear to compensate for involuntary termination and not to provide an early retirement benefit, retirement-type subsidy, or social security supplement. Furthermore, although the Taxpayer asserts that the benefit is provided to those who leave the Taxpayer=s employment voluntarily, the facts indicate that the plan is designed to provide benefits to those whose services are terminated. The plan does not appear to qualify for the special transition rule offered for window benefits.

[redacted]. However, the Final Regulations include transition rules which govern how the Service will respond to an employer=s treatment of amounts deferred or benefits paid prior to January 1, 2000. Certainly the Service should follow its own regulations and the specific transition

rules in responding to a taxpayer=s claim for refund.[10] In applying these rules, we do not believe that Taxpayer=s claims for refund with respect to severance pay and stock option grants satisfy the explicit requirement for a reasonable, good faith interpretation for all the reasons discussed in the above section.

[redacted].

[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 and the stock options 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 that conclusion are faulty for the reasons discussed above.

Finally, the administrative importance of these issues supports disallowing Taxpayer=s claims for refund in accordance with the legal position discussed above. Both severance pay and stock options have been the subject of numerous claims for refund filed after the publication of the Proposed Regulations, many involving significant dollar amounts. 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. Additionally, because Taxpayer did not treat all

---

[10] We note that Congress has prohibited administrative exclusions from FICA tax. See S.Rep. No. 98-23, 98th Cong., 1st Sess., at 42 (1983 U.S.Code Cong. & Adm.News 183); H.Rep. No. 98-25, 98th Cong., 1st Sess., at 80 (1983 U.S. Code Cong. & Adm.News 299).

stock option grants since the inception of section 3121(v)(2) in 1983 as subject to the special timing rule, Taxpayer=s claim for refund also should be denied.

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

Jerry E. Holmes
Chief, Branch 2 (EBEO)
Office of Associate Chief Counsel
(Employee Benefits & Exempt
Organizations)