Legal Opinion L-2002-04
March 21, 2002

U.S. Railroad Retirement Board
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TO : James A. Verplaetse
Chief of Payment Analysis and Systems

FROM : Steven A. Bartholow
General Counsel

SUBJECT : Federal Tax Reports for Penalty Deductions

This is in reply to your inquiry of February 5, 2002, requesting my advice as to whether penalty deductions assessed against annuitants under the Railroad Retirement Act (RRA) for failure to make timely excess earnings reports may be included as repayments for purposes of the agency's obligations under the Internal Revenue Code. For the reasons discussed below, I find that these deductions may be reported as repayments.

Your memorandum states that since May 1995, penalties have been combined with the underlying erroneous payment amount in agency receivables accounting, and have not been segregated for recovery purposes from the erroneous annuity payment caused by the claimant's earnings. As a result, when the annuitant repays the erroneous payment amount (whether by cash refund, offset in monthly annuities, or actuarial adjustment in future annuities), the penalty amount is included as annuities "repaid" for purposes of the Board's reporting responsibilities under the Internal Revenue Code. Your memorandum suggests first, that late report penalties should not be considered erroneous benefit payments in the same sense as the underlying annuity deduction for earnings; and second, that you believe collection of a penalty is not a "repayment" within the meaning of the Code, and hence should be reported differently under the relevant Code provisions.

With respect to the initial question, I note that penalty deductions for untimely earnings reports in non-disability[1]cases derive from four separate provisions of the Railroad Retirement Act.[2] Pursuant to section 2(f)(1) of the Act, certain components of an employee age and service annuity:

> * * * shall be subject to deductions on account of work pursuant to the provisions of section 203 of the Social Security Act in the same manner as if such portion of such annuity were a monthly insurance benefit under that Act * * * . Any person in receipt of an annuity subject to deduction under this subsection shall report to the Board the

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[1] Section 2(e)(4) of the RRA requires disability annuitants who earn more than $400 in a month to report to the Board any such payment of earnings for such employment or self-employment before the receipt and acceptance of an annuity for the second month following the month of such payment, and imposes an additional deduction in the annuity of an employee who fails to make such report. The deductions pursuant to section 2(e)(4) are not the subject of your inquiry, and are not addressed by this memorandum.

[2] Although deductions may also be imposed against certain annuity components for continuation in last person employment pursuant to section 2(e)(6), no additional deductions are specified for untimely reporting of such employment.

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> receipt of excess earnings as defined in paragraph (3) of section 203(f) of the Social Security Act.

Section 2(f)(2) of the RRA further states that certain components of spouse and divorced spouse annuities:

> shall be subject to deductions on account of work pursuant to the provisions of section 203 of the Social Security Act in the same manner as if such portion of such spouse's annuity were a monthly insurance benefit under that Act.

Annuity deductions for the earnings of survivor annuitants are set forth at section 2(g)(2) of the RRA in pertinent part as follows:

> (2) Deductions, in amounts and at such time or times as the Board shall determine, shall be made from any payments to which a survivor is entitled under subsection (d) until the total of such deductions equals such survivor's annuity under that subdivision for any month, if for such month such survivor would be charged with excess earnings under section 203(f) of the Social Security Act * * *
>
> For purposes of this subdivision, the Board shall have the authority to take such actions and to make such determinations and such suspensions of payment of benefits in the manner and to the extent that the Secretary of Health and Human Services would be authorized to take or to make under section 203(h)(3) of the Social Security Act.

Employee annuities (and the annuities of spouses, where applicable) are also subject to deductions for excess earnings when paid under the social security over-all minimum guaranty provision (section 3(f)(2)) of the RRA, which limits the increase only to:

> * * * the total amount * * * which would have been payable to all persons for such month under the Social Security Act if such individual's service as an employee after December 31, 1936, were included in the term "employment" as defined in that Act * * *.

The foregoing provisions of the RRA all incorporate, directly or inferentially, section 203 of the Social Security Act (42 U.S.C. 403), which specifies the method by which monthly benefits of the insured beneficiary and family members are reduced for certain events, including earnings. Insofar as is relevant here, section 203(b) establishes the deduction for earnings; section 203(f) defines earnings to be charged against monthly benefits, including calculation of earnings exceeding the annual maximum; section 203(h)(1) establishes the beneficiary's reporting duties; and section 203(h)(2) imposes additional benefit deductions for late reporting of earnings, as follows:

> (h)(2) If an individual fails to make a report required under paragraph (1) of this subsection, within the time prescribed by or in accordance with such paragraph, for any taxable year and any deduction is imposed under subsection (b) of this section by reason of his earnings for such year, he shall suffer additional deductions as follows:
>
> (A) if such failure is the first one with respect to which an additional deduction is imposed under this paragraph, such additional deduction shall be equal to his benefit * * * for the last month of such year for which he was entitled to a benefit, ***except * * * [if less than a full month was withheld under 203(b) for excess earnings for the last month, then] the additional deduction shall be equal to the amount of the deduction imposed under subsection (b) of this section but not less than $10;

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(B) if such failure is the second one * * * such additional deduction shall be equal to two times his benefit * * * for the last month of such year * * *;

(C) Such failure is the third or a subsequent one * * * such additional deduction shall be equal to three times his benefit * * * for the last month of such year * * *;

In January 1995, the former Director of Retirement and Survivor Programs informed this office that in recovering the penalty deductions in employee and spouse annuities imposed by section 2(f) of the RRA,

> It has long been RRB policy that penalty deduction amounts are not considered to be overpayments in the strictest definition of “overpayments” and, therefore, are not entered on the program accounts receivable (PAR) [computerized debt tracking] system. It has also been RRB policy to suspend the annuity to recover the penalty * * * and then recover the overpayment [by the means selected by the annuitant]. SSA adds the penalty deduction amount into the overpayment and recovers the entire amount (penalty and overpayment) following their standard recovery procedures. If [recovery by] partial withholding is requested [by the beneficiary], SSA applies that [recovery by] partial withholding to the penalty as well.

In Legal Opinion L-95-7, the General Counsel advised the Director that in view of the language of section 2(f) of the RRA that retirement annuities shall be “subject to deductions on account of work pursuant to the provisions of section 203 of the Social Security Act in the same manner” as benefits paid under that Act, no legal objection existed to prevent revision of the Board’s procedure to correspond with that of the Social Security Administration. The first question raised by your current memorandum is whether the advice provided by L-95-7 is correct.

My review of the matter leads me to conclude that L-95-7 reached the correct conclusion under the law. Legal Opinion L-95-7 approved a change in administration of the RRA based upon an interpretation of a parallel provision of the Social Security Act by the SSA. Of course, deductions for earnings applied to retirement annuities under section 2(f), as well as deductions applied to survivor annuities under section 2(g)(2) and to annuities increased under the social security minimum guaranty provision of section 3(f)(2), can only be made pursuant to Board’s authority to administer the benefit provisions of the Railroad Retirement Act. See section 7(b) of the RRA. Decisions made by the Social Security Administration (SSA) in the course of that agency’s duty to administer the Social Security Act cannot supplant the Board’s duty under section 7(b), since the SSA has no authority with regard to benefit decisions under the RRA. However, where Congress has explicitly borrowed from the Social Security Act in a provision of the RRA, and where no other provision of the RRA manifests any Congressional intention to have the two Acts diverge, the Acts should be interpreted symmetrically. McCoy v. Railroad Retirement Board, 935 F. 2d 87, (5th Cir., 1991) at 88 (holding that the tier I component of a disability annuitant under the RRA must be reduced for a worker’s compensation benefit as provided by section 224(a) of the Social Security Act). It has been stated that to have the two agencies look at the same set of facts under the same rules but arrive at contrary decisions creates a public image of unfairness and conflict within the government. Sones v. United States Railroad Retirement Board, 933 F. 2d 636, (8th Cir., 1991), at 637. In a determination by the Board of the meaning of the parallel provision of the RRA, the interpretation of the Social Security Act by the SSA is therefore entitled to deference. Social Security Board v. Nierotko, 327 U.S. 358 (1945), at 366-367. In particular, the language of the survivor annuity earnings deduction provision has been held to be in pari materia with section 203 of the Social Security Act. Linquist v. Bowen, 813 F. 2d 884, (8th Cir., 1987), at 889.

There is no information regarding the basis for the SSA’s interpretation of section 203(h). However, I note that although the term “penalty” is used in the SSA’s regulation regarding failure

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to timely report earnings (20 CFR 404.453), the statute itself merely characterizes the deduction for late earnings reports as a "deduction". Given the language of the Social Security Act, I cannot say that the SSA wrongly interpreted the additional deductions required by untimely earnings reports to be a portion of the erroneous payment. Legal Opinion L-95-7 therefore correctly advised deductions for untimely earnings reports imposed pursuant to section 2(f) of the RRA may be accounted for and recovered in the same fashion as late report deductions under section 203(h) of the Social Security Act.
Moreover, in my opinion this analysis applies with equal force to deductions for late earnings reports imposed under sections 2(g)(2) and 3(f)(2) of the RRA as well.

The second question posed by your memorandum is whether, even if the penalty and erroneous payments may be combined in the Board's receivables accounting system and for purposes of recovering the payments from the annuitant, the penalty nevertheless must be segregated for purposes of statements to the annuitant and returns to the Internal Revenue Service. Since the methods whereby annuities under the RRA may be included as taxable income to the annuitant are specified by two disparate sections of the Internal Revenue Code, you also inquire whether the law allows the same treatment of late filing penalty deductions under both.

As you know, section 86 of the Code (26 U.S.C. 86) provides that a "tier I railroad retirement benefit" is subject to taxation on the same basis as are benefits under the Social Security Act. See section 86(d)(1) of the Code (26 U.S.C. 86(d)(1)). The "tier I" for purposes of section 86 is defined as the "social security equivalent" portion of the tier I annuity component and any monthly annuity paid under the social security minimum guaranty provision of the RRA (RRA section 3(f)(2)). See section 86(d)(4) of the Code. Section 86(d)(2) of the Code further provides:

> (2) Adjustment for repayments during year. (A) In general. For purposes of this section the amount of social security benefits received during any taxable year shall be reduced by any repayment made by the taxpayer during the taxable year of a social security benefit previously received by the taxpayer (whether or not such benefit was received during the taxable year.)
>
> (B) Denial of deduction. If (but for this subparagraph) any portion of the repayments referred to in subparagraph (A) would have been allowable as a deduction for the taxable year under section 165, such portion shall be allowable as a deduction only to the extent it exceeds the social security benefits received by the taxpayer during the taxable year (and not repaid during such taxable year).

Code section 6050F(a)(1) (26 U.S.C. 6050F(a)(1)) imposes upon the Board a duty to file with the IRS a return for social security equivalent benefits which sets forth the "(A) aggregate amount of social security benefits paid with respect to any individual during any calendar year,[and] (B) aggregate amount of social security benefits repaid by such individual during such calendar year * * *. " Subsection 6050F(b)(2) further requires that the Board " * * * shall furnish to each individual [annuitant] * * * a written statement showing * * * the aggregate amount of payments, of repayments, and of reductions" for the taxable year. The Board thus has a duty to provide the annuitants with information necessary to file a return of income taxable under section 86 of the Code, and to apprise the IRS of information necessary to audit the accuracy of the taxpayer's return.

Legal Opinion L-95-7 addressed only the issue of recovery of the late report deduction from the annuitant and related internal agency accounting. Information was not provided to the General Counsel at that time regarding the corresponding reporting of the additional deduction for Federal tax purposes. Further, your memorandum does not state whether the SSA has modified its returns and statements under IRC section 6050F to accord with its recovery methods. Even

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assuming that is the case, the interpretation of the Code by the SSA is not due the same deference as is that agency's interpretation of it's own statute. See: Adams Fruit Co. v. Barrett, 494 U.S. 638, 649 (1990)(congressional delegation of administrative authority is a precondition to deference to agency's interpretation of law). For this reason, this office advised the former Director of Taxation in Legal Opinion L-91-99 that "there is no requirement that the computation of the SSEB amount conform in every way to the procedures of the SSA * * * " Nevertheless, given the identical definition of SSEB and social security benefit under the Code, and the bias of the law in favor of uniform application of the RRA and the Social Security Act, there is certainly no legal objection which prevents the Board from conforming performance of its responsibilities under the Code regarding SSEB amounts to the methods adopted by the SSA, where the SSA is not clearly incorrect.

In this regard, the suggestion in your memorandum that SSA's interpretation is incorrect because a taxpayer cannot net a penalty against benefits paid under section 86(d)(2) of the Code in the same manner as the taxpayer could net a repayment of benefits is not without merit. For example, section 162(f) of the Code (26 U.S.C. 162(f)) explicitly states that ordinary and necessary expenses incurred in a trade or business shall not include "any fine or similar penalty paid to a government for a violation of any law." See also, regulations of the Treasury at 26 CFR 1.162-21. Where no specific tax legislation or Treasury regulation precludes a deduction, it is well settled that a deduction will be denied where allowance would frustrate a sharply defined national policy proscribing a particular form of conduct and evidenced by some governmental declaration of it. See: Annotation, *Modern Status of Rule Dealing with Public Policy as Ground for Denying Deduction for Federal Income Tax Purposes*, 16 L. Ed.2d 1117,(1967) at 1120.

Section 86(d)(2)(B), quoted above, states that a taxpayer may claim a deduction under section 165 of the Code in a year where the amount of repayment of a social security benefit (or SSEB) is greater than the total benefits received in a taxable year. Section 165(c)(2) (26 U.S.C. 165(c)(2)) allows individual taxpayers to claim a loss "incurred in any transaction entered into for profit, though not connected with a trade or business". As section 165 has no provision excluding penalties per se, whether an item may not be deducted must be determined under the general public policy rule. However, making a payment to a government for a violation of law may not automatically mean the payment constitutes a non-deductible penalty. See: Annotation, *Income tax: Deductibility of Amount Paid or Expense Incurred by Taxpayer on Account of His Liability or Alleged Liability for Tort, Crime, or Statutory Violation*, 20 A.L. R. 2d 600 (1951), at 606. In particular, it has been said that an exception may be available for "late filing or interest charges" imposed "to encourage prompt compliance with filing or other requirements". Colt Industries v. United States, 880 F. 2d 1311, (Fed. Cir., 1989) at 1313, (discussing the legislative history of section 162(f)). Based on the foregoing, I cannot say that a decision of the SSA to include in its section 6050F return and statement any late filing deduction paid by a beneficiary as a deductible "repayment" is incorrect. There is consequently no legal objection to the Board doing so with respect to its duties under 6050F as well.

The last question raised by your memorandum is whether the Board's duties under the Code regarding late earnings report penalties may differ with respect to the remaining, "non-social security equivalent benefit" (non-SSEB) portion of annuities under the RRA. As you know, section 72(r) of the Code (26 U.S.C. 72(r)) provides that the remaining portion of an annuity under the RRA shall be income to the employee to the same extent as a private pension under an employer plan. That section does not include a provision for allocating repayments comparable to 86(d)(2). Further, section 6050G(a)(1) of the Code (26 U.S.C. 6050G(a)(1)) requires the Board to file a return to the IRS showing "the aggregate amount of benefits paid under the Railroad Retirement Act of 1974 (other than [social security equivalent] * * * benefits * * *) to any individual during any

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calendar year". Section 6050G(b) directs the Board to furnish annuitants with a written statement showing "the aggregate amount of payments to such individual, and of employee contributions with respect thereto, required to be shown on the return".

This office has previously considered the absence from section 6050G of the requirement to report aggregate repayments as well as aggregate amounts paid. Legal Opinion L-94-38 specifically advised that "In view of the absence of the word "repayment" in section 6050G as well as the absence of a netting rule in section 72(r) * * * there would appear to be no requirement to report repayments under section 6050G." See also Legal Opinion L-2002-2 (concerning repayment of annuities paid in prior years which are rendered erroneous due to later cancellation of the annuity application). However, while the Board has no duty under 6050G to report repayments, neither is it prohibited from supplying this information. See Legal Opinion L-94-35 (the Board may provide statement to estate under 6050G of non-SSEB repayment to facilitate estate's determination of decedent's income and estate tax liabilities). For the reasons discussed above with respect to reports of SSEB amounts under 6050F, I therefore find no legal objection to including in the amount of recovered annuities any deductions for untimely earnings reports pursuant to sections 2(f) and 2(g)(2) of the RRA, in returns and statements issued under section 6050G of the Internal Revenue Code.

cc: Director of Policy and Systems