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June 08, 2006

Legend
State A -
Political Subdivision Employer X -
Political Subdivision Employer Y -
Political Subdivision X -
Political Subdivision Y -
Date 1 -
Date 2 -
Date 3 -
Statute M -

Dear :

This is in response to your request for a ruling dated , supplemented by correspondence dated , on the applicability of the continuing employment exception to Medicare under Internal Revenue Code (Code) section 3121(u)(2)(C) to certain firefighters subsequent to the merger of Political Subdivision Employers X and Y.

Facts

Political Subdivision Employers X and Y are fire protection districts in State A. On Date 2, the voters of Political Subdivision X approved the merger of Political Subdivision Employer X into Political Subdivision Employer Y in accordance with Statute M, which provides rules and procedures governing the merger of fire protection districts. Effective on Date 1, Political Subdivision Employer X, a political subdivision employer of State A, merged into Political Subdivision Employer Y, also a political subdivision employer of State A, pursuant to a concurrent resolution adopted by the Boards of Commissioners of Political Subdivisions X and Y on Date 3. Effective Date 1, employees of Political Subdivision Employer X were transferred to Political Subdivision Employer Y. Of those transferred, eight employees had been employed by Political

Subdivision Employer X prior to April 1, 1986. Those eight employees employed by Political Subdivision Employer X prior to April 1, 1986, were employed in good faith, were hired for purposes other than avoiding Medicare taxes, and were performing regular and substantial services for pay. Additionally, those eight employees of Political Subdivision Employer X are performing the exact same duties at the exact same fire stations as they did before the merger into Political Subdivision Employer Y.

You have requested a ruling that the employees of Political Subdivision Employer X, who were hired before April 1, 1986, and who before the merger were eligible for the continuing employment exception under Code section 3121(u)(2)(C), will continue to be eligible for the exception following the merger.

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." Code sections 3101, 3111, and 3121. 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." Code sections 3101, 3111, and 3121.

Services performed by an employee of a state, political subdivision, or wholly owned instrumentality not covered by a 218 Agreement are exempt from employment for purposes of the OASDI portion of FICA only if the employee is a member of a retirement system of such state, political subdivision, or wholly owned instrumentality. Code section 3121(b)(7)(F). Services performed by employees of a state, political subdivision, or wholly owned instrumentality who are hired after March 31, 1986, who are not subject to a 218 Agreement, are considered to be employment for purposes of applying the Medicare tax. Code section 3121(u)(2). The Code, however, provides a narrow exception to the Medicare tax, known as the continuing employment exception, if specific requirements are met. Code section 3121(u)(2)(C).

For employment to qualify for the continuing employment exception, an employee's services performed for a particular state, political subdivision, or wholly owned instrumentality must satisfy the following requirements enumerated in Code section 3121(u)(2)(C):

1. The employee's services are excluded from the term "employment" as determined in Code section 3121(b)(7)(F), which exclusion generally applies only to an employee who is a member of a retirement system of such state, political subdivision, or wholly owned instrumentality. See cross-reference in Code section 3121(u)(2)(C)(i) to Code section 3121(u)(2)(A) which cross-references

Code section 3121(b)(7). This rule is effective for services performed after July 1, 1991. Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, section 11332(b)(3), 101st Cong., 2d Sess. (1990). See also Revenue Ruling 2003-46, 2003-1 C.B. 878.

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

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

4. The employee's employment relationship was not entered into for purposes of satisfying the requirements of Code section 3121(u)(2)(C).

5. The employee's relationship with the employer has not been terminated after March 31, 1986.

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

(i) All agencies and instrumentalities of a State (as defined in section 218(b) of the Social Security Act) or the District of Columbia shall be treated as a single employer.
(ii) All agencies and instrumentalities of a political subdivision of a State (as so defined) shall be treated as a single employer and shall not be treated as described in clause (i).

Revenue Ruling 86-88, 1986-2 C.B. 172, and 88-36, 1988-1 C.B. 343, provide guidelines for use in applying the continuing employment exception and the applicability of the Medicare tax. Revenue Ruling 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, town, village, or school district. Revenue Ruling 86-88 also provides that the term "political subdivision employer" includes the political subdivision and any agency or instrumentality of that political subdivision that is a separate employer for purposes of withholding, reporting, and paying the federal income taxes of employees. Under these definitions, for example, if an employee simply ceased working as a firefighter for one political subdivision employer and began working as a firefighter for another political subdivision employer in a different political subdivision, that employee would have transferred from one political subdivision employer to another political subdivision employer, and, thus, that employee could not satisfy the continuous employment requirements of Code section 3121(u)(2)(C)(iii).

However, the case of 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 that was formed when three formerly independent school districts merged into one was found not to be a new employer for purposes of the continuing employment exception. The court turned to legislative history to determine that the purpose of Code section 3121(u)(2)(C) was to protect state and local government agencies from a sudden increase in Medicare taxes. H.R. Rep. 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 taxpayer was not a new employer for its post-merger employees, who in substance continued to work for the same employer under a different name. Thus, the consolidation of the school districts did not result in the creation of a new employer, nor did the consolidation disqualify employees from eligibility for the continuing employment exception of Code section 3121(u)(2)(C).

We conclude that the merger in this case is governed by Board of Education of Muhlenberg County v. United States. Accordingly, the merger of Political Subdivision Employer X into Political Subdivision Employer Y did not give rise to a new employer. Therefore, for purposes of the continuing employment exception of Code section 3121(u)(2)(C), the firefighters who had been continuously employed by Political Subdivision Employer X prior to April 1, 1986, will not be considered to have terminated their employment as a result of the merger.

Consequently, we hold that the firefighters of Political Subdivision Employer X hired before April 1, 1986, and previously entitled to the continuing employment exception to Medicare pursuant to Code section 3121(u)(2)(C), continued to be eligible for such exception following the merger of Political Subdivision Employers X and Y, provided they are employees of Political Subdivision Employer Y, and are members of a retirement system within the meaning of Code section 3121(b)(7)(F).

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, this is not a ruling as to whether any retirement system maintained by State A or Political Subdivision Employers X or Y satisfies the requirements of Code section 3121(b)(7)(F) and the regulations thereunder.

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.

The ruling contained in this letter is 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.

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)