

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **200410005**

Release Date: 03/05/2004

Index Number: 3121.15-00

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:ET2:PLR-140033-03

Date:

December 01, 2003

Attention:

Legend:

= State A  
= Political Subdivision 1  
= Political Subdivision 2

= Political Subdivision 3

= Statute  
= Date

Dear

This is in response to a request made on your behalf dated May 12, 2003, as supplemented by your letter dated September 4, 2003, for a letter ruling concerning the applicability of the Medicare tax exemption contained in section 3121(u)(2)(C) of the Internal Revenue Code (Code) to certain firefighters and police officers subsequent to the consolidation of Political Subdivision 1 and Political Subdivision 2 and the creation of Political Subdivision 3.

## Facts

On Date, pursuant to Statute and on approval of the voters, Political Subdivision 1 and Political Subdivision 2 were consolidated into new Political Subdivision 3. Prior to the consolidation certain police officers and firefighters had been continuously employed by Political Subdivision 1 from before April 1, 1986, through the date of the consolidation.

Those police officers and firefighters employed by Political Subdivision 1 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, the employment relationship between the police officers and firefighters and Political Subdivision 1 had not been terminated at any time after March 31, 1986, and before the consolidation. Thus, while employed by Political Subdivision 1, the police officers and firefighters were not subject to Medicare taxes under the continuing employment exception of Code section 3121(u)(2)(C).

Subsequent to Date the police officers and firefighters continued to work in the same positions and to perform the same duties notwithstanding the consolidation of Political Subdivision 1 and Political Subdivision 2 and the creation of new Political Subdivision 3. All rights, privileges, and protections attributed to the police officers and firefighters by Political Subdivision 1 and all labor contracts between the police officers and firefighters and Political Subdivision 1 continued in effect. The police officers and firefighters retained their pre-consolidation status, seniority, benefits, and other attributes of employment. Additionally, you have represented that police officers and firefighters historically employed by Political Subdivision 1 participate in a retirement system intended to comply with the requirements of Code section 3121(b)(7)(F) and the regulations thereunder.

## Law and Analysis

Federal Insurance Contributions Act (FICA) taxes consist of the old-age, survivors, and disability (OASDI) portion and the hospital insurance portion (Medicare tax) and are computed as a percentage of wages paid by the employer and received by the employee for employment. Code sections 3101, 3111, 3121. Generally, all remuneration by an employer for services performed by an employee is subject to FICA taxes unless the remuneration is specifically excepted from the term "wages" or the services are specifically excepted from the term "employment". Code sections 3101, 3111, 3121.

Services performed by an employee of a state, political subdivision, or wholly owned instrumentality not covered by a 218 Agreement are generally 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 an employee of a state, political subdivision, or wholly owned instrumentality not subject to a 218 Agreement are generally considered to be employment for purposes of applying Medicare tax. Code section 3121(u)(2). However, the Code provides a narrow exception to Medicare tax, known as the continuing employment exception, if specific requirements are satisfied. 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 must be excluded from the term "employment" as defined 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), 101<sup>st</sup> Cong., 2d Sess. (1990); see also Rev. Rul. 2003-46, 2003-19 I.R.B. 878, May 12, 2003.
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) provides the following rule with regard to the determination of employer for purposes of the continuing employment exception. The rule provides that:

- (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, provides guidance concerning 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, city, 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, if an employee simply ceased working as a firefighter or police officer for Political Subdivision 1 and began working as a firefighter or police officer for Political Subdivision 2, he or she would have transferred from one political subdivision employer to another political subdivision employer and, thus, could not satisfy the continuous employment requirement of Code section 3121(u)(2)(C)(iii).

However, the case of Board of Education of Muhlenberg County v. U.S., 920 F.2d 370 (6<sup>th</sup> Cir. 1990) holds that the Code does not explicitly address the application of the continuing employment exception in cases of merger or consolidation of political subdivisions. 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. No. 99-241, 99<sup>th</sup> 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 using the continuing employment exception of Code section 3121(u)(2)(C).

We conclude that the consolidation in this case is governed by Board of Education of Muhlenberg County v. U.S. Pursuant to Statute, Political Subdivision 1 and Political

Subdivision 2 were consolidated and became Political Subdivision 3. Incidental to this consolidation the police officers and firefighters who had been continuously employed by Political Subdivision 1 prior to April 1, 1986, continued their employment with Political Subdivision 3.

Consequently, we hold that the police officers and firefighters of Political Subdivision 1 hired before April 1, 1986, and previously entitled to the Medicare tax continuing employment exception pursuant to Code section 3121(u)(2)(C) continue to be eligible for such exception if they 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 the retirement system satisfies the requirements of Code section 3121(b)(7)(F) and the regulations thereunder.

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 ruling, it is subject to verification on examination.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the attorney who submitted this request on your behalf.

Sincerely,

Marie Cashman  
Acting Chief, Employment Tax Branch 2  
Office of the Assistant Chief Counsel  
(Exempt Organizations/Employment  
Tax/Government Entities)

cc