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The Honorable John Duncan
Member, U.S. House of Representatives
800 Market Street, Suite 110
Knoxville, Tennessee 37902

Dear Congressman Duncan:

This is in response to your inquiry dated , on behalf of the employees of the . The employees raised several questions concerning the taxation of employer contributions to Internal Revenue Code (Code) section 401(k) plans and Code section 457(b) deferred compensation arrangements. The employees are specifically concerned that "unlike 401(k)'s and other retirement plans, our 457(b) plan must withhold social security and Medicare taxes on the employer's contribution."

A deferred compensation arrangement is any plan, program, or agreement under which an employer promises to pay an amount to an employee at some future date for his past, present, or in some cases, further services. A deferred compensation arrangement can be either "qualified" or "Nonqualified." As a general rule, a plan must contain numerous specific statutorily mandated provisions in order to be treated as a "qualified plan" under Code section 401(a), including funding, nondiscrimination, employee coverage, distribution, and other requirements.

Deferred compensation arrangements have the basic advantage of deferring income tax on amounts contributed by the employer to the plan until they are distributed to the employee. However, contributions to deferred compensation arrangements may or may not be subject to taxes under the Federal Insurance Contributions Act (FICA) at the time they are made, depending on the type of arrangement.

FICA taxes are imposed on wages paid with respect to employment. [Code section 3101]. Generally all remuneration an employer pays for services an employee performs is subject to FICA taxes unless the law specifically excepts the remuneration from the term "wages" or excepts the services from the term "employment." [Code sections 3101, 3111, and 3121].

The law specifically excepts from wages contributions an employer makes on behalf of an employee to a tax qualified plan that satisfies all the requirements of Code section

401(a). [Code section 3121(A)(5)(A)]. In contrast, the law provides that an employer contribution under a qualified cash or deferred arrangement under Code section 401(k) is included in wages and subject to FICA tax. [Code section 3121(v)(1)(A)]. A qualified cash or deferred arrangement is one that allows an employee to elect to have the employer's contribution made to the plan on the employee's behalf or directly to the employee in the form of cash or some other taxable benefit.

Similarly, amounts deferred under a section 457(b) plan are includable in wages and subject to FICA taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount. [Code section 3121(v)(2)(A)]. This generally means that the amounts are subject to FICA tax at the time of deferral. Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers. State and local governments and tax-exempt organizations are eligible employers. An eligible State deferred compensation plan is one that meets the requirements of Code section 457(b).

The letter asserts that the FICA taxation of amounts deferred under a Code section 457(b) plan discourages rather than encourages savings, and this taxation discriminates against employees covered by a 457(b) plan, when contributions to other plans are exempt from FICA taxation.

It was not the intent of Congress to discourage participants in 457(b) plans and similar arrangements from saving for retirement. Rather the purpose of Congress in enacting the provision of IRC section 3121(v) was to protect the Social Security wage base. Code section 3121(v) was enacted as part of the Social Security Act Amendments of 1983, Public Law 98-21. In Senate Report No. 98-23, March 11, 1983, the Senate Committee on Finance provides insight into the reasons Congress enacted section 3121(v).

> Generally, if an employee receives cash and then chooses too use these funds for personal savings or benefits, the amount of cash received in subject to FICA. This is true, for example, for contributions to an individual retirement account (IRA) even if the employer transmits the funds directly to the IRA account.
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> Under cash or deferred arrangements, certain tax-sheltered annuities, certain cafeteria plans, and eligible State deferred compensation plans, the employer contributes funds which are set aside by individual employees for individual savings arrangements, and thus, the committee believes that such employer contributions should be included in the FICA base, as is the case for IRA

contributions. Otherwise, individuals could, in effect, control which portion of their compensation was to be included in the social security wage base. This would make the system partially elective and would undermine the FICA tax base.

I hope this information is helpful. Please contact me at or if you need further assistance.

Sincerely,

Catherine E. Livingston
Assistant Chief Counsel Exempt Organizations/ Employment Tax/Government Entities)
(Tax Exempt & Government Entities)