Office of Chief Counsel
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Memorandum

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to: Sunita B. Lough, Director
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subject: Salary Reduction under section 3121(v)(1)(B)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
State =
Retirement System =
Statute A =
Statute B =
X% =
Y% =
Z% =

ISSUE

Whether Taxpayer's employer contributions under § 414(h)(2) of the Internal Revenue Code were paid pursuant to a salary reduction under § 3121(v)(1)(B) and, consequently, are wages for FICA tax purposes.

CONCLUSION

Taxpayer's employer contributions under § 414(h)(2) were not paid pursuant to a salary reduction under § 3121(v)(1)(B) and, consequently, are not wages for FICA tax purposes.

FACTS

Taxpayer is a public school district.[1] Statute A requires Taxpayer to participate in the Retirement System. Statute B requires Taxpayer's eligible employees to participate in the Retirement System. Participation in the Retirement System is mandatory; employees may not elect out of the Retirement System.

The total contribution to the Retirement System equals X% of each employee's salary. Statute A requires Taxpayer to contribute an amount equal to Y% of each employee's salary to the Retirement System. Similarly, Statute B requires each employee to contribute Z% of their salary to the Retirement System. Statute B also authorizes Taxpayer to pay all employee contributions made after a specified date "in order to be treated as employer contributions for the sole purpose of determining tax treatment under the United States Internal Revenue Code, section 414(h)."

Pursuant to Statute B Taxpayer may pay the employee contributions by a reduction in the employee's cash salary. Alternatively, Taxpayer may pay the employee contributions without a salary reduction or offset. In accordance with Statute B Taxpayer pays the employee contributions from the source of funds used to pay the employee's salary but does not withhold the contributions from the employee's salary. Rather, after implementing the employer contribution, Taxpayer pays the employee's salary without reduction or offset for the amount designated as an employee contribution. Taxpayer makes a supplemental contribution to the Retirement System in an amount equal to the designated employee contribution in satisfaction of the employee's obligation under Statute B.

In each of the years in which Taxpayer initiated employer contributions pursuant to Statute B Taxpayer increased the employees' compensation in an amount consistent with historical salary increases. Taxpayer did not withhold or pay FICA taxes with

[1] Taxpayer is covered by a § 218 agreement between State and the Social Security Administration. Consequently, wages paid by Taxpayer to its employees are subject to FICA taxes.

respect to amounts contributed by Taxpayer to the Retirement System pursuant to Statute B.

LAW

Pursuant to § 414(h)(1) any amount contributed to an employees' trust described in § 401(a) is not treated as having been made by the employer if it is designated as an employee contribution. Pursuant to § 414(h)(2), however, an exception applies for qualified plans established by the government of any State or political subdivision thereof, or by any agency or instrumentality of the forgoing. Pursuant to this exception where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up are treated as employer contributions.

Congress enacted § 414(h) as part of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406. Section 414(h) codifies earlier administrative rulings and judicial decisions regarding the tax treatment of amounts designated as employee contributions. Congress explained the operation and effect of § 414(h) as follows:

> Under present law, contributions which are designated as employee contributions are generally treated as employee contributions for purposes of the Federal tax law. . . . Your committee's bill contains a provision to clarify this rule for the future. This provision provides that amounts that are contributed to a qualified plan are not to be treated as an employer contribution if they are designated as employee contributions.
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> However, some State and local government plans designate certain amounts as being employee contributions even though statutes authorize or require the relevant governmental units or agencies to "pick up" some or all of what would otherwise be the employee's contribution. In other words, the governmental unit pays all or part of the employee's contribution but does not withhold this amount from the employee's salary. In this situation the portion of the contribution which is "picked up" by the government is, in substance, an employer contribution for purposes of Federal tax law, notwithstanding the fact that for certain purposes of State law the contribution may be designated as an employee contribution. Accordingly, the bill provides in the case of a government pick-up plan, that the portion of the contribution which is paid by the government, with no withholding from the employee's salary, will be treated as an employer contribution under the tax law.

H.R. Rep. No. 93-807, 93rd Cong., 2nd Sess. 145 (1974),1974-3 C.B. (Supp.) 236, 380.

Pursuant to § 3121(a) the term "wages" for FICA tax purposes means all remuneration for employment unless specifically excepted. Pursuant to § 3121(a)(5)(A), however, wages do not include any payment made to, or on behalf of, an employee or his

beneficiary from or to a qualified plan unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust. Nevertheless, pursuant to § 3121(v)(1)(B), wages include any amount treated as an employer contribution under § 414(h)(2) where the employer picks up the contribution pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise).

As originally enacted in the Social Security Amendments of 1983, Pub. L. No. 98-21, § 3121(v)(1)(B) included in wages for FICA tax purposes "any amount treated as an employer contribution under § 414(h)(2)." However, Congress intended to include in wages for FICA tax purposes only those amounts that would have been included in wages had the employer made the contribution pursuant to a salary reduction. Consequently, in the Deficit Reduction Act of 1984, Pub. L. No. 98-369, Congress amended § 3121(v)(1)(B) to provide that employer pickups are wages for FICA tax purposes only if the employer picks up the contribution pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise).[2]

ANALYSIS

The issue for determination is whether Taxpayer's employer contributions under § 414(h)(2) were paid pursuant to a salary reduction under § 3121(v)(1)(B) and, consequently, are wages for FICA tax purposes.

Section 3121(v)(1)(B) includes in wages any amounts treated as employer contributions under § 414(h)(2) where the employer picks up the contributions pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise). For purposes of § 3121(v)(1)(B) the term "salary reduction" relates to amounts treated as an employer contribution under § 414(h)(2) that would have been included in wages for FICA tax purposes but for the employer contribution. Thus a salary reduction occurs if the amounts included in wages for FICA tax purposes (without regard to § 3121(v)(1)(B)) are less than they otherwise would have been but for the employer contribution. Conversely, no salary reduction occurs if the amounts included in wages for FICA tax purposes are equal to what they otherwise would have been but for the employer contribution.

The amounts that would have been included in wages for FICA tax purposes but for the employer contribution are determined based on the facts and circumstances that

[2] In the House conference report accompanying the Deficit Reduction Act of 1984 Congress acknowledged the unintended scope of § 3121(v)(1)(B) as originally enacted and clarified its intentions with respect to the amendment: "Prior to the Social Security Amendments of 1983, certain employer payments ('pickups') of employee contributions under a state or local retirement plan were treated as wages for social security and unemployment tax purposes only if the payments were made under a salary reduction arrangement. Under the amendments, all such employer payments are treated as wages." H.R. Conf. Rep. No. 98-861 at 1415 (1984).

determine the employee's compensation under the overall employment relationship. In this case the facts and circumstances establish that the amounts included in wages for FICA tax purposes are equal to what they otherwise would have been.[3] Taxpayer's contributions in accordance with Statute B did not reduce or offset any amounts due and owing to the employees. Taxpayer paid the employer contributions in addition to—not in lieu of—all remuneration for services owed to the employees under the terms and conditions of the employment relationship. Additionally, Taxpayer paid the employer contributions in addition to—not in lieu of—salary increases that were consistent with historical norms. Thus, under the facts and circumstances determining the employee's compensation, Taxpayer did not pay the employer contributions under § 414(h)(2) in lieu of current or future compensation that would have been included in wages for FICA tax purposes but for the employer contribution.

Whether an employer contribution under § 414(h)(2) is made pursuant to a salary reduction or a salary supplement is determined relative to the amounts that would have been included in wages for FICA tax purposes but for the employer contribution.[4] A salary increase does not affect this analysis—the employer must pay both the employee's original salary and the salary increase to avoid a salary reduction. With a salary reduction the employer pays the employer contribution with funds derived from the employee's original salary and pays the employee an amount equal to the salary increase. Thus, notwithstanding the salary increase, the amounts included in wages for FICA tax purposes (without regard to § 3121(v)(1)(B)) are less than they otherwise would have been but for the employer contribution. With a salary supplement, however, the employer pays the employer contribution with supplemental funds and pays the employee an amount equal to the aggregate of the employee's original salary and the salary increase.[5] Only by determining what the employee's total salary would have been but for the employer contribution is it possible to determine whether the employer contribution is made pursuant to a salary reduction or a salary supplement.

The fact that Taxpayer could have further increased the employees' compensation in lieu of making an employer contribution does not support the determination that

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[3] Compare the facts and circumstances of this case with those in Public Employees' Retirement Board v. Shalala, 153 F.3rd 1160 (10th Cir. 1998) and Revenue Ruling 81-36, 1981-1 C.B. 255 wherein the amounts included in wages for FICA tax purposes (disregarding § 3121(v)(1)(B)) were less than they otherwise would have been but for the employer contribution.

[4] Absent an employer contribution under § 414(h)(2) an employer generally pays an amount designated as an employee contribution with after-tax dollars via a salary deduction. Thus the employer includes the employee contribution in wages for FICA tax purposes but does not pay the employee contribution in cash to the employee.

[5] In Revenue Ruling 65-208, 1965-2 C.B. 383 the Internal Revenue Service distinguished between salary reduction contributions (made from the funds of the employee) and salary supplement contributions (made from the funds of the employer). The salary reduction contributions were held to be subject to FICA taxes whereas the salary supplement contributions were not subject to FICA taxes. Although Revenue Ruling 65- 208 does not use the term "salary supplement contributions" courts have subsequently used this terminology to explain the distinction drawn by Revenue Ruling 65-208.

Taxpayer would have further increased the employees' compensation but for the employer contribution. Only if Taxpayer would have increased the employees' compensation are the amounts relevant in determining whether Taxpayer made the employer contributions pursuant to a salary reduction. The mere possibility of a salary increase—unsupported by the facts and circumstances determining the employee's compensation—does not demonstrate that the employer contributions were made pursuant to a salary reduction under § 3121(v)(1)(B). Similarly, the fact that Taxpayer pays the employee contributions from the source of funds used to pay the employee's salary does not demonstrate that the amounts would have been currently included in wages for FICA tax purposes but for the employer contribution.

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Please call (202) 622-6040 if you have any further questions.