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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ALLEN P. JONES
DIRECTOR, FEDERAL, STATE, AND LOCAL GOVERNMENTS

FROM: Lynne Camillo
Chief, Employment Tax Branch 2
Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) CC:TEGE:EOEG:ET2

SUBJECT: FICA Taxation of State section 403(b) plan

This Chief Counsel Advice responds to your request for assistance. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent. This advice should be distributed to the field office having jurisdiction of this taxpayer and refund claims related to this issue.

LEGEND

State C =

Plan A =

Plan B =

Employer =

r =

s =

t =

u =

v =

x =

y =

w =

q =

Governing Body Z =

Program D =

ISSUE

Whether contributions made pursuant to a section 403(b) plan under the circumstances described below are made by reason of "salary reduction agreements" and therefore are wages for Federal Insurance Contributions Act (FICA) tax purposes under section 3121(a)(5)(D).

CONCLUSION

These contributions are made by reason of salary reduction agreements and are not excluded from wages by section 3121(a)(5)(D). Therefore, the contributions are wages for purposes of the FICA. Refund claims for FICA taxes with respect to these contributions to Plan A should be denied.

FACTS

Employees of the Employer are generally covered for FICA tax purposes pursuant to the section 218 agreement between State C and the predecessor of the Secretary of Health and Human Services. State C maintains a retirement program (Plan B) for employees of the State, including employees of the Employer. Plan B is a defined benefit pension plan intended to be qualified under section 401(a). The designated "employee contributions" to Plan B are intended to be "picked up" within the meaning of section 414(h). The amount contributed from the employee's salary to Plan B is equal to s percent of compensation.

Plan A has been established and approved by Governing Body Z. Certain employees ("Eligible Employees") of the Employer are eligible to participate in Plan A; however, the employee must choose to participate in Plan A rather than Plan B. The copy of Plan A provided (Revised q) allows employees to choose the rate of salary reduction contribution from their compensation subject to a required minimum level provided under Plan A and subject to limitations under the Internal Revenue Code. There is a required minimum level of contributions by the employee to Plan A equal to v percent of compensation, except that contributions for employees with less than x years of service have a required minimum rate of u percent for the first t of compensation and v percent for compensation in excess of t. Matching employer contributions are made at the rate of y percent of compensation, except that contributions for employees with less than x years of service are made at the rate of w percent for the first t of compensation and y percent for compensation in excess of t. The required rate (y) of contribution by the employee to Plan A for compensation applicable to employees with x years of service and applicable to compensation in excess of t for employees with less than x years of service is considerably higher than the rate provided for salary reduction contributions to Plan B. However, the required rate of contribution by the employee applicable to employees with less than x years of services (w percent) for the first t of compensation is lower than the rate provided for salary reduction contributions to Plan B.

Plan A provides that "compensation" means the individual's budgeted salary which is the current salary amount appearing opposite each person's name in the Employer budget and on their official notice of appointment. Compensation is defined as excluding compensation for correspondence study, Saturday and evening classes, overtime pay, shift differential, special bonus payments, any other irregular service payment, and any compensation in the form of noncash benefits.

Under Plan A, an employee who is an "Eligible Employee" may make a one-time irrevocable election to participate in Plan A. Such one-time irrevocable election shall be made upon the date of employment at the Employer or, if later, when the employee first becomes an eligible employee. An Eligible Employee who elects to participate must complete the necessary enrollment forms and return them to the Employer. A participant will continue to participate in Plan A until he or she ceases to be an Eligible Employee, or until the plan is terminated, whichever occurs first.

Plan A has a section entitled “Contributions Made by Salary Reduction” which provides that contributions by a participant shall be made on a tax-deferred basis. Contributions shall be forwarded to the funding vehicle permitted by the Employer and selected by the participant. In addition to participant plan contributions that are required by a participant, Plan A provides that each participant may make voluntary “elective deferrals” by entering into a salary reduction agreement.

The summary description of Plan A provides that a participant can make tax-deferred contributions above the amount required for participation. These contributions above the required minimums are not matched by the Employer. The summary description states that to make contributions above the required minimum on a tax-deferred basis, the participant must enter into a “salary reduction agreement” with the Employer, which can be cancelled at any time. The description further provides that all tax-deferred contributions must be included on the same “salary reduction agreement,” executed in accordance with section 403(b). It is stated the contributions will not exceed the limits established for tax-favored retirement plans. Despite the terms of Plan A and the plan description, the Employer states that it has a separate Program D under which contributions in excess of the required minimums may be made by an employee and such contributions are not made under Plan A.

Plan A provides that the participant is fully and immediately vested in amounts attributable to plan contributions when such plan contributions are made. The Employer is the administrator of Plan A.

Under Plan A, plan contributions will begin each year when the Employer has determined that the participant has met or will meet the requirements for a year of a participation. Any part of a year’s plan contributions not contributed prior to the determination will be included in contributions made for that year after the determination.

An “Eligible Employee” for purposes of Plan A is defined as any full time permanent staff member and part-time permanent staff member working at least 50 percent time earning at least r dollars annually. The term Eligible Employee excludes students, interns, externs, fellows, residents, temporaries and visiting faculty and staff members who are receiving benefits from their home institutions.

New hires of the Employer attend a benefits orientation session and are informed at that time that they are eligible to participate in either Plan A or Plan B. The employees receive information about the plans and of the different rates of required salary reduction contributions to each plan. At the orientation session each employee receives an enrollment form for both retirement plans. Employees who wish to sign up for Plan A and have the minimum level of salary reduction simply complete an enrollment form for Plan A. According to the taxpayer, if the employee chooses a level of salary reduction other than the minimum level, the employee also executes a form entitled "salary reduction agreement" providing for the employee's salary reduction contributions to Program D on the agreement. Staff in the Employer benefits office verifies an employee is signed up in only one plan.

This memorandum concerns the FICA taxation of the contributions to Plan A from the salaries of employees that are required under the terms of Plan A. There is no dispute that the salary reduction contributions in excess of the required minimums under Plan A are subject to FICA taxes. The Employer states that FICA taxes were paid on the contributions at issue in this memorandum (i.e., the contributions from the salaries of the employees required under the terms of Plan A), but that it filed a claim for refund with respect to the FICA tax payments. The Employer requested a ruling on the status of these contributions, but withdrew its ruling request.

LAW AND ANALYSIS:

Sections 3101 and 3111 impose FICA taxes on employees and employers, respectively, equal to a percentage of the wages received by an individual with respect to employment.

Section 3121(a)(5)(D) provides that wages do not include any payment made to, or on behalf of, an employee or his beneficiary under or to an annuity contract described in section 403(b), other than a payment for the purchase of such contract which is made by reason of a salary reduction agreement (whether evidenced by a written instrument or otherwise). Employee contributions (i.e., after-tax contributions) made through salary deductions and used to purchase annuity contracts are includible in wages for FICA tax purposes.

Section 403(b)(1) provides that amounts contributed by certain employers for the purchase of an annuity contract for an employee are excludable from the gross income of the employee if certain requirements are satisfied. While annuity contracts described in section 403(b) are generally purchased with amounts contributed by an employer, the employer's contributions are not required to be "merely a supplement to past or current compensation." Treas. Reg. §1.403(b)-1(b)(3). Thus the exclusion is applicable to amounts contributed by an employer for an annuity contract as a result of an agreement with an employee to take a reduction in salary. As with wages for FICA tax purposes, employee contributions made through salary deductions and used to purchase annuity contracts are includible in the employee's gross income.

A. Background

The historical treatment of the FICA taxation of contributions to section 403(b) plans is useful in understanding current law. In addition, the taxpayer has maintained that the historical treatment and legislative history of the enactment of section 3121(a)(5)(D) and related provisions support its position that the contributions at issue are not wages. This history of FICA taxation has been shaped by concern for the protection of the social security revenue base and employees' social security benefits. The concern is reflected in the broad interpretation of taxable "wages" for purposes of the FICA taxation of contributions to such plans. That broad interpretation of "wages" has justified the concept that, in this context, "wages" for FICA tax purposes is a broader term than income for income tax purposes. Thus, even though employer contributions to a section 403(b) annuity contract are excludable from gross income, such contributions are subject to FICA taxes if they are made by reason of a salary reduction agreement.

1. Rev. Rul. 65-208

The principle that FICA taxation applies to certain section 403(b) contributions was set forth in Rev. Rul. 65-208, 1965-2 C.B. 383. In that ruling, an employee entered into an agreement with a nonprofit organization to take a reduction in salary for the purpose of providing funds for the purchase of an annuity contract meeting the requirements of section 403(b). The salary reduction amounts were excludable from the employee's gross income for purposes of section 403(b) as employer contributions to a section 403(b) plan and were not subject to federal income tax withholding.

At that time, section 3121(a)(2) in the FICA provisions contained an exception from the definition of wages for payments made by an employer under a plan on behalf of an employee on account of retirement. However, the ruling held that a determination under section 403(b) that a particular amount is "contributed by the employer" for purposes of section 403(b) does not necessarily require a similar determination that it is also an amount "paid by an employer" under section 3121(a)(2). The ruling noted that the purposes of section 403(b) and section 3121(a)(2) are "substantially different."

The ruling concluded that the amounts contributed to the section 403(b) plan pursuant to the salary reduction agreement were wages for purposes of the FICA. Rev. Rul. 65-208 distinguished an earlier ruling, Rev. Rul. 181, 1953-2 C.B. 111, which had held that an exempt organization's payment for the purchase of an annuity contract on behalf an employee was not wages for purposes of the FICA. Rev. Rul. 65-208 states that Rev. Rul. 181 "contemplates a situation where an organization uses its own funds for the purchase of an annuity contract, rather than one where the employee takes a voluntary reduction in salary to provide the necessary funds."

Thus, in Rev. Rul. 65-208, a distinction was made 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 the terminology "salary supplement" contribution was not used in Rev. Rul. 65-208, discussions of the ruling in later litigation discussed below have used this terminology to explain the distinction drawn by Rev. Rul. 65-208.

2. Rowan Companies v. United States

A Supreme Court case called the validity of Rev. Rul. 65-208 into question. In Rowan Companies, Inc. v. United States, 452 U.S. 247 (1981), the Supreme Court considered whether amounts (the value of meals and lodging) that were excludable from gross income under section 119 and not subject to income tax withholding were wages subject to FICA taxes. The Court overturned a long-standing Treasury regulation and held that the amounts were not wages for FICA tax purposes. In this decision, the Supreme Court set forth the principle that the definition of wages for social security tax purposes and the definition of wages for income tax withholding purposes must be interpreted in the same manner in the absence of statutory provisions to the contrary. The Rowan principle could be interpreted as conflicting with Rev. Rul. 65-208, because Rev. Rul 65-208 applies FICA taxes without explicit statutory authority to amounts that were not subject to federal income tax withholding.

3. Social Security Amendments of 1983

Congress quickly acted to reverse the potential effect of the Supreme Court's holding on section 403(b) contributions and to overturn the rationale of Rowan, while also codifying the narrow holding of the case excluding from wages amounts qualifying as excludable from income under section 119. Section 3121(a)(5)(D), which applied FICA taxation to section 403(b) contributions made by reason of a salary reduction agreement, was added by the Social Security Amendments of 1983, Public Law No. 98-21 (hereinafter "1983 Amendments").

In discussing present law related to the FICA taxation of section 403(b) plans, the Senate Finance Committee stated as follows in connection with the 1983 Amendments:

> The Internal Revenue Service has ruled that amounts paid for a tax-sheltered annuity pursuant to a salary reduction agreement are includible in the

> employee's social security wage base, even though such amounts may not be subject to income tax withholding. The validity of the ruling position is in doubt in light of the Supreme Court decision in Rowan Companies, Inc. v. United States (see following section of this report).

Senate Rep. No. 98-23, 98th Cong., 1st Sess. 39 (1983).

The "reasons for change" section of the Senate Report discussed the concept of subjecting to FICA taxes funds set aside by an individual under section 403(b) plans and also mentioned the importance of maintaining FICA tax revenue:

> 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.

Senate Report No. 98-23 at 40.

The taxpayer cites this language as indicating Congressional intent that mandatory contributions cannot be the subject of a salary reduction agreement. This interpretation appears questionable, because in the same committee report, the Senate Finance Committee specifically declined to elaborate on what constituted a salary reduction agreement.

The committee report evidences Congress' concern with making inclusion of compensation in the "social security wage base" elective; it does not support the notion that the new law was aimed at only those plans that give the employees an option to receive cash. Thus, if two alternatives are available to an employee and one option results in the exclusion of an amount from FICA wages and the other option results in the inclusion of the amount in FICA wages, that would be a situation Congress sought to avoid, regardless of whether the employee had any option to receive cash.

For that reason, the above language from the legislative history supports the position that the Plan A contributions were intended to be treated as wages for purposes of the FICA. Under the current facts, if the employee remains in Plan B and does not elect Plan A, the contributions deducted from his or her salary will be subject to FICA taxes under Public Employees' Retirement Board v. Shalala, 153 F.3d 1160 (10th Cir. 1998), which held that mandatory pick-up contributions made pursuant to a state statute were wages for FICA tax purposes. However, the taxpayer maintained that if the employee elects to participate in Plan A, the salary reduction amount should not be subject to FICA taxes. The taxpayer's position would "make the system partially elective and would undermine the FICA tax base" in contravention of the concern expressed in the legislative history.

The above language from the Senate Report is also consistent with the distinction made in Rev. Rul. 65-208 between salary reduction contributions and salary supplement contributions. The salary reduction agreement contributions are set aside from the funds of the employee.

The Senate Report indicated that the Senate Finance Committee did not intend to define what constituted a salary reduction agreement for purposes of section 3121(a)(5)(D), but did intend to codify the holding of Rev. Rul. 65-208. Senate Report No. 98-23 states at page 41:

> The bill also provides that any amounts paid by an employer to a tax-sheltered annuity by reason of a salary reduction agreement between the employer and the employee would be includible in the employee's social security wage base. The committee intended that the provision would merely codify the holding of Revenue Ruling 65-208, 1965-2 C.B. 383, without any implication with respect to the issue of whether a particular amount paid by an employer to a tax-sheltered annuity is, in fact, made by reason of a "salary reduction agreement".

The 1983 Amendments, as finally enacted by Congress, imposed FICA taxes on a number of deferred compensation items where the employee had no option to receive the payment in cash or where participation was required by the employer. One example is certain nonqualified deferred compensation plans. Amounts deferred under such plans would be subject to FICA taxes when no substantial risk of forfeiture existed, even if the deferral from the employee's salary is mandatory. As part of the legislative changes enacted in 1983, Congress also enacted a provision providing that pick-up contributions would be includible in the FICA wage base (section 3121(v)(1)(B)). Under the provision enacted by Congress these contributions from the employees' salaries could only be treated as FICA wages if they were required by law. The taxpayer's argument that only voluntary contributions from the employees' salaries were intended to be included in FICA wages is in direct conflict with the scope of the final legislation. Of the particular plans named in the excerpt from the Committee report discussing making the system partially elective, eligible state deferred compensation plans can be funded with mandatory contributions, and are nevertheless still subject to FICA tax under the 1983 Amendments.

The principal distinction drawn in the committee reports is between contributions made from funds set aside by individual employees and contributions made from funds of the employer. The above language from the Senate Report is consistent with the distinction made in Rev. Rul. 65-208 between salary reduction contributions and salary supplement contributions. The salary reduction agreement contributions are set aside from the funds of the employee.

The Conference Report on the 1983 Amendments approached the issue of what constituted a salary reduction agreement differently. The Conference Report related to the 1983 Amendments described this legislative change as follows:

> The conference agreement generally follows the Senate amendment by providing that employer contributions to a section 403(b) annuity contract would be included in the wage base if made by reason of a salary reduction agreement (whether evidenced by a written agreement or otherwise). For this purpose, the conferees intend that employment arrangements, which under the facts and circumstances are determined to be individually negotiated, would be treated as salary reduction agreements. Of course, the mere fact that one individual is receiving employer contributions (e.g., when the employer has only a few employees, only one of whom is a member of a class eligible for such contributions) is not, by itself, to be considered proof of individual negotiation.

H.R. Rep. No. 98-47, 98th Cong., 1st Sess 147 (1983).

The taxpayer places reliance on the second sentence of the above-quoted material as representing the exclusive definition of what constitutes a salary reduction agreement, regardless of whether a written document purporting to be a salary reduction agreement exists. However, the second sentence must be read together with the first sentence. The second sentence may be viewed as a partial explanation of what is included in the “or otherwise” language in the first sentence and is not intended to limit the scope of actual written salary reduction agreements. It is intended to define certain situations other than actual written agreements which could meet the definition of salary reduction agreement, and is further explained by the third sentence of the quoted material. Contrary to the taxpayer’s argument, there is nothing in the quoted material indicating that the second sentence is intended to define exclusively what constitutes a salary reduction agreement. If the taxpayer’s interpretation were correct, there would be no vehicle under which compulsory contributions could become employer contributions rather than employee contributions.

The second part of the 1983 Amendments that is of importance in this context is the amendment made to overturn the broad rationale of Rowan. This provision, which is referred to as the "anti-Rowan amendment" is codified in the penultimate sentence of section 3121(a). The anti-Rowan amendment provides that nothing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from "wages" as used in such chapter shall be construed to require a similar exclusion from "wages" in the regulations prescribed for purposes of the FICA.

The 1983 Amendments were the result of a Congressional effort to "assure the solvency of the Social Security Trust Funds." Conf. Rep. 98-47 at 115. The 1983 Amendments extended coverage, raised FICA taxes, imposed income tax on social security benefits, and cut certain benefits in order to place the social security system on a sounder financial footing. The Senate report gave the following reason for adding the anti-Rowan amendment:

> The social security program aims to replace the income of beneficiaries when that income is reduced on account of retirement and disability. Thus, the amount of "wages" is the measure used both to define income which should be replaced and to compute FICA tax liability. Since the [social] security system has objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion.

Senate Report No. 98-23 at 42.

In addition, Congress amended the FICA to eliminate the exception from "retirement" provided by section 3121(a)(2) for payments under employer plans on account of retirement. Generally, this amendment had the effect of limiting exceptions from FICA wages for retirement plans to specific exceptions provided for employer contributions to certain qualified plans under section 3121(a)(5), such as the exception at issue here.

Section 3121(a)(5)(D), as added by the 1983 Amendments, could be read as reinstating the distinction between salary reduction agreement contributions and salary supplement contributions in Rev. Rul. 65-208. In addition, the concept set forth in Rev. Rul. 65-208 that FICA wages can include amounts that are not includible in gross income was, in effect, incorporated into the statute by the anti-Rowan amendment.

4. Deficit Reduction Act of 1984

The Congressional concerns of protecting the social security funding base, preserving the social security benefits of section 403(b) participants, and reinstating the validity of Rev. Rul. 65-208 were further evidenced in 1984. When Congress changed the effective date rules of the anti-Rowan amendment in the Deficit Reduction Act of 1984 (DEFRA), the change was designed to stem the possibility of refunds of FICA tax with respect to salary reduction agreement contributions under tax-sheltered annuities for periods prior to the effective date of section 3121(a)(5)(D). In effect, through passage of this provision, Congress sought to insure that Rev. Rul. 65-208 would be effective for prior periods in situations where the employer treated the contributions as subject to FICA taxes. See section 2662(g)(2) of DEFRA and Canisius College v. United States, 799 F.2d 18 (2d Cir. 1986). Section 2662(g)(2) of DEFRA provided that the anti-Rowan amendment "shall apply to remuneration ... paid after March 4, 1983, and to any such remuneration paid on or before such date which the employer treated as wages when paid." The legislative history in connection with this change provides as follows:

> If the 1965 revenue ruling were determined to be invalid, then employers and employees would be eligible for refunds for open years because taxable wages would be lower. In addition, wages for benefit computation purposes would be reduced, leading in some cases to reduction of social security benefits being paid to current beneficiaries and recoupment of a portion of benefits which have been paid in recent years on the basis of wage records which included the salary reduction contributions.

H.R. Rep. 98-432, 98th Cong., 2d Sess. 1658 (1984).

The 1984 effective date change was also designed to insure that the prior effective date provision (remuneration paid after March 4, 1983) would not be used "as demonstrating Congressional intent that the reasoning of the Rowan decision should generally apply before these dates to types of remuneration other than meals and lodging excluded under section 119, e.g., to contributions under a salary reduction agreement to tax-sheltered annuities (sec. 403(b))." H. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 1414 (1984). The legislative history also states as follows in describing the effect of the 1984 amendment: "for example, if an employer treated as wages, for FICA and FUTA taxes (or both), the amounts contributed during 1982 to an employee's tax-sheltered annuity pursuant to a salary reduction agreement, the FICA or FUTA taxes (as the case may be) paid by the employer and employee may not be refunded or credited." H.R. Rep. No. 98-432 at 1658. These 1984 changes again demonstrate the importance of the revenue protection feature of the 1983 Amendments, and further support the view that the intent of Congress was to essentially incorporate the holding of Rev. Rul. 65-208 into the statute.

Also as part of the DEFRA, Congress amended section 3121(v)(1)(B) to add language referencing a "salary reduction agreement (whether evidenced by a written instrument or otherwise)" identical to the language in section 3121(a)(5)(D). The Conference Report stated as follows:

> The conferees intend that the term salary reduction agreement also includes any salary reduction arrangement, regardless of whether there is approval or choice of participation by individual employees or whether such approval or choice is mandated by State statute.

H. Conf. Rep. No. 98-861 at 1415.

Although the general rule is that legislative history of later enacted legislation (in this case, the amendment to section 3121(v)(1)(B)) is given limited effect in interpretations of prior legislation (section 3121(a)(5)(D)), that rule must be considered in the context of the 1984 legislation. In this case the same Congress in a different session is providing its intended interpretation of identical language. As noted above, the 1984 legislation, by changing the effective date of the anti-Rowan amendment, was designed to insure in effect that section 3121(a)(5)(D) and the codification of Rev. Rul. 65-208 would be effective for prior years for those taxpayers who had paid FICA taxes on salary reduction contributions to section 403(b) plans. Congress was clearly focused on the taxation of section 403(b) plans in the 1984 legislation, so that its interpretation of identical language added to the same Code section in the legislation is entitled to weight.

We would also note that the change in the anti-Rowan effective date and the amendment to section 3121(v)(1)(B) are discussed seriatim in the Conference Report with the preface that "[o]nly the following two provisions [relating to Technical Corrections to the Social Security Amendments of 1983] require additional explanation." House Conf. Rep. 98-861 at 1413. Also, there is no indication in the committee reports that the interpretation given "salary reduction agreement (whether evidenced by a written instrument or otherwise)" in the Conference Report is intended to be restricted to section 3121(v)(1)(B) and not to reflect its meaning for purposes of other identical language in section 3121. Under these circumstances, it is reasonable to consider this Congressional statement as reflecting a Congressional understanding of what this language found elsewhere in the same Code provision would mean.

5. Section 403(b) refund suits

Taxpayers brought many refund suits seeking refunds of FICA taxes paid with respect to section 403(b) contributions for years prior to 1983 and challenging the constitutionality of the changed effective dates of the 1984 Amendments. In a series of cases, courts upheld the Service's denial of the refund claims. These cases emphasized the distinction between salary reductions and salary supplements that is the focus of determining whether FICA taxes apply to section 403(b) contributions. See Temple University v. United States, 769 F.2d 126, 130 (3d Cir. 1985), which supports the distinction drawn by Rev. Rul. 65-208 between salary reduction contributions and contributions from the employer's own funds. See New England Baptist Hospital v. United States, 807 F.2d 280, 282 (1st Cir. 1986), which rejected the distinction made by the Government in Rev. Rul. 65-208 between "salary reductions" and "salary supplements" and stated that "[i]n 1983, Congress amended the statutes to codify Revenue Ruling 65-208." The court in New England Baptist also stated that the 1983 law had the effect of "making it clear that salary reduction plans are subject to FICA taxes." Id. at 284. See Canisius College, 799 F.2d at 20-21, which also acknowledged the distinction between "salary reduction plans" and "salary supplement plans." The court in Canisius College concluded that "the 1984 provision retroactively validated previously unlawful FICA taxes paid on amounts contributed under salary reduction plans in conformity with Revenue Ruling 65-208." Id, at 22.

6. Summary

Since the publication of Rev. Rul. 65-208, a distinction has existed for FICA tax purposes between employer contributions made by salary reduction agreement to section 403(b) plans and employer contributions made by salary supplement to section 403(b) plans. This distinction is reflected in the legislative history of changes made in 1983 and 1984 to the FICA provisions. This established distinction supports the position that the contributions made to the annuity contracts under Plan A pursuant to the documents signed by the employees are made under "salary reduction agreements" for FICA tax purposes and are wages for FICA tax purposes.

B. Distinction between Employee Contributions and Employer Contributions Made to Retirement Annuity Contracts

The taxpayer has argued that these contributions are mandatory contributions from the salaries of the employees and therefore, are not made pursuant to a salary reduction agreement. If the taxpayer were correct that these contributions from the employee's salaries are not made pursuant to a salary reduction agreement, then case law and Service authority would indicate that the contributions would be employee contributions rather than employer contributions for FICA tax purposes. If the contributions are employee contributions to the section 403(b) plan, the issue of whether section 3121(a)(5)(D) applies would not even be reached. Section 3121(a)(5) applies only to employer contributions to the listed plans in the subparagraphs of section 3121(a)(5). No exception is provided for employee contributions to such plans Thus, employee contributions to section 403(b) plans simply fall within the basic definition of wages under section 3121(a) with no applicable exception. Accordingly, if the contributions were employee contributions made by salary deduction rather than employer contributions made by salary reduction agreement, the contributions would also be subject to FICA taxes.

Rev. Rul. 56-473, 1956-2 C.B. 22, concerns the treatment for income tax purposes of amounts deducted from the salaries of public employees of the State of Arizona and credited to their retirement accounts pursuant to the state's retirement system. Half of the contributions were specified as contributions by the employee from the salary of the employee. The ruling concludes that, for income tax purposes, compulsory contributions designated as employee contributions should be treated as employee contributions for purposes of the employee's annuities. Accordingly, the ruling held that amounts deducted from the compensation of employees of the State of Arizona and credited to their retirement accounts constituted gross income within the meaning of section 61(a) and should be reported in the employees' annual income tax returns for the year in which deducted.

Rev. Rul. 57-326, 1957-2 C.B. 42, holds that where an ordinance or statute of a municipality or state provides for a state employees' retirement plan, under which employee participation is compulsory and an employee's contributions are refunded in the event of termination of the employee's service prior to retirement or death, the amount of the employee's contributions which have been deducted from the salary of the employee by the employer shall be included in the employee's gross income for income tax purposes.

Rev. Rul. 72-94, 1972-1 C.B. 23, concerns the status of contributions made where, under an ordinance or statute of a municipality or state or the rules of a governing body of an organization establishing an employees' nonqualified pension or retirement plan, participation is mandatory and the ordinance, statute, or other rules (1) require the employee to forfeit his contributions in the event of termination of service prior to death or before becoming eligible for retirement, or (2) are silent as to the refund of employee contributions and, in the administration of the plan, no refund will be made in such event. The ruling concludes that the amounts withheld from the salary of an employee as contributions to the plan and applied solely to provide deferred pensions are to be treated as employer contributions under the plan. Accordingly, it was held that those contributions were not includible in the employee's gross income for the year in which so contributed. Consistent with Rev. Rul. 57-326, Rev. Rul. 72-94 also holds that where only a portion of the contributions is required to be forfeited in the event of the termination of the employee's services, amounts not subject to forfeiture are required to be included in the employee's gross income each year.

The courts have reached similar conclusions with regard to whether compulsory contributions to state retirement plans are properly characterized as employer contributions or employee contributions. In Zwiener v. Commissioner, 743 F.2d 273 (5th Cir. 1984), the court held that mandatory employee contributions to the Employees Retirement System of Texas were includible in income, on either of two grounds:
(1) compulsory employee contributions are refundable upon termination of employment for reasons other than death or retirement; (2) amounts contributed purchase (in the nature of an annuity) some valuable present economic benefit. The court cited similar cases holding that amounts contributed by federal employees to the federal civil service retirement system are income received by the employees subject to federal income taxation.

In Howell v. United States, 775 F.2d 887 (7th Cir. 1985), the court held that compulsory contributions to a state retirement plan of amounts designated as employee contributions and withheld from the employee's salary are employee contributions includible in the employee's gross income. See also Feistman v. Commissioner, 63 T.C. 129 (1974) and Feistman v. Commissioner, 35 T.C.M. 1045 (1976).

Similarly, Rev. Rul. 72-250 holds that the portion of a United States Government employee's compensation that is withheld and contributed to the United States Civil Service Retirement and Disability Fund is a contribution by the employee to such fund and is includible in his gross income in the same taxable year in which it would have been included had it been paid to him directly. This ruling is consistent with other cases considering the status of contributions from employees' salaries to the United States Civil Service Retirement and Disability Fund. See Taylor v. Commissioner, 2 T.C. 267 (1943), aff'd sub nom. Miller v. Commissioner, 144 F.2d 287 (4th Cir. 1944); Megibow v. Commissioner, 21 T.C. 197 (1953), aff'd, 218 F.2d 687 (3d Cir. 1955); Cohen v. Commissioner, 63 T.C. 267 (1974), aff'd per curiam, 543 F.2d 725 (9th Cir. 1976); and Hogan v. United States, 367 F.Supp. 1022 (E.D. Mich. 1973), aff'd, 513 F.2d 170 (6th Cir. 1975), cert. denied, 423 U.S. 836 (1975).

Congress subsequently endorsed and codified the characterization of compulsory contributions as employee contributions with the enactment of section 414(h)(1) as part of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406 (Sept. 2, 1974) (ERISA). Code section 414(h)(1) provides that an amount contributed to an employees' trust described in section 401(a) will not be treated as having been made by the employer if it is designated as an employee contribution.[1]

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[1] Section 414(h)(2) provides an exception to the general rule stated above for state or local pick up plans. In such plans, certain governmental units or agencies pick

While the statutory designation test of section 414(h) does not literally apply to nonqualified plans, the legal principles embodied in section 414(h) do. The legislative history to ERISA provides the following explanation regarding the significance of designating a contribution as either an employer contribution or an employee contribution under the plan:

> Designated contributions.–Under present law, contributions which are designated as employee contributions are generally treated as employee contributions for purposes of the Federal tax law. For example, this is the case with respect to employee contributions under the Federal Civil Service plan. 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.
>
> This provision gives effect to the source of the contributions, as designated in the plan. For example, if the appropriate committees of the Congress were to report legislation regarding employee contributions under the Federal Civil Service plan so that the present employee's contributions would become employer contributions under the Federal Civil Service plan (and that legislation were to be enacted), then those contributions would constitute employer contributions to the plan, which would be excludable from the employee's income when made. The same rule would apply to State and local governmental plans which now designate contributions as employee contributions, if the appropriate governmental bodies change the provisions of their plans.

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

In accordance with the forgoing administrative, judicial, and legislative authority, the following three factors are relevant in determining whether compulsory contributions made pursuant to a nonqualified defined contribution plan and used to purchase retirement annuity contracts are employer contributions or employee contributions for purposes of section 403(b) and section 3121(a)(5)(D): 1) whether the contributions are compulsory under state or local law or are otherwise a

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up what would otherwise be an employee contribution by not withholding the employee contribution from the employee's salary. The amount picked up is treated as an employer contribution under section 414(h)(2).

condition of employment; 2) whether the contributions are designated as employee contributions and are deducted from the employee's base pay, salary, or compensation; and 3) whether the contributions are fully vested and nonforfeitable when credited to the employee's retirement account.

In the instant case, the contributions at issue are required under the terms of Plan A approved by Governing Body Z, although the employee must make an election to participate in Plan A rather than Plan B. The contributions are designated as participant contributions and are deducted from the employee's base pay or salary. The contributions are also fully vested and nonforfeitable when credited to the employee's retirement account. Accordingly, these contributions, absent a legally binding salary reduction agreement, have the characteristics of employee contributions under the three-factor test described in the preceding paragraph.

The issue arises whether compulsory contributions made pursuant to a legally binding salary reduction agreement constitute employer contributions for purposes of section 3121(a)(5)(D). Under the facts of Rev. Rul. 70-582, 1970-2 C.B. 95, a state statute required employee contributions toward retirement and permitted such contributions to be made by salary reduction agreements or salary deduction. The ruling concluded that if the employer entered into a valid salary reduction agreement with the employee, the compulsory contributions were employer contributions and the income tax exclusion provisions of section 403(b) were applicable to the contributions. The ruling demonstrates the dichotomy between compulsory contributions made by salary reduction agreement, which are employer contributions, and compulsory contributions made by salary deduction, which are employee contributions.

In University of North Dakota v. United States, 603 F.2d 702 (8th Cir. 1979), the court held that a salary reduction agreement could be effective to defer income taxation, if it is adopted in lieu of mandatory employee contributions to a state plan. Under the facts of the case, employees were given an option to make annuity contributions through salary deductions or to have their salary reduced by the amount that would otherwise be deducted from their salaries. Under the court's ruling, if an employee enters into a legally binding salary reduction agreement, a compulsory contribution that would otherwise be taxable as an employee contribution may be taxable as an employer contribution if such characterization is not inconsistent with statutory intent or with the underlying plan.

C. Interpretations of Salary Reduction Agreement in section 402(g)(3) and 403(b)

For income tax purposes, the question of whether a salary reduction agreement exists is significant for several purposes. Under section 403(b)(12), differing nondiscrimination requirements apply based on whether a salary reduction agreement exists. Also, under sections 403(b)(7) and 403(b)(11), the situations in which distributions may be made differ based on whether a salary reduction agreement exists. In addition, the question of whether the elective deferral limitations apply may depend upon whether a salary reduction agreement exists. See section 403(b)(1)(E) and section 402(g)(3)(C). Difference in interpretation of the term “salary reduction agreement” for FICA and for other purposes has been incorporated into the statute with respect to certain matters.

For example, the term “salary reduction agreement” is defined in a manner different from the FICA for the purpose of determining whether a section 403(b) plan meets the nondiscrimination requirements of section 403(b)(12). See the flush language after section 403(b)(12)(A)(ii), which states that for purposes of section 403(b)(12)(A)(i), a contribution shall be treated as not made pursuant to a salary reduction agreement if under the agreement it is made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the program or is made pursuant to a similar arrangement involving a one-time irrevocable election specified in regulations.

In section 403(b)(12)(A), Congress created a special rule for salary reduction agreements to the effect that a contribution will not be deemed to be pursuant to such an agreement if it is made pursuant to a one-time irrevocable election. No such special rule was placed in section 3121(a)(5)(D). It is well-settled that “where Congress included particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.” Gozlon-Peretz v. United States, 498 U.S. 395, 404 (1991), quoting Russello v. United States, 464 U.S. 16, 23 (1983). Although the ordinary, common meaning of “agreement” would include an agreement made pursuant to a one-time irrevocable election, Congress created a special rule in section 403(b)(12)(A) that was explicitly made applicable only to clause (i) of that section. Thus, it may be inferred that Congress intentionally decided not to incorporate this special rule into section 3121(a)(5)(D).

The legislative history of section 402(g)(3) offers further support that Congress intended a broad interpretation of salary reduction agreement in section 3121(a)(5)(D). This legislative history indicates the distinction between salary reduction agreements and elective deferrals. The legislative history supports the conclusion that contributions made pursuant to a salary reduction agreement are not necessarily treated as elective deferrals for purposes of section 402(g)(3). The language in section 402(g)(3) indicates that the agreements in the instant case could be salary reduction agreements, but not elective deferrals. Section 402(g)(3) provides that for purposes of section 402(g), the term “elective deferral” means, with respect to any taxable year, the sum of several types of contributions including...(C) any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)). The last sentence of section 402(g)(3) further provides that "[a]n employer contribution shall not be treated as an elective deferral described in subparagraph (C) if under the salary reduction agreement such contribution is made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the agreement or is made pursuant to a similar arrangement involving a one-time irrevocable election specified in regulations."

Section 402(g) was added by section 1105(a) of the Tax Reform Act of 1986, and was amended to add the last sentence in section 402(g) by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). Section 402(g) originally listed several items that were included within the term "elective deferrals" but did not provide for what was not included within the term.

Our interpretation of the distinction between elective deferrals and salary reduction agreements for purposes of section 3121(a)(5)(D) is supported by the legislative history related to the 1986 and 1988 amendments. The Conference Report for the Tax Reform Act of 1986, H. R. Rep. 99-841, 99th Cong., 2d Sess. (1986) II-405 is careful to use the term "elective deferrals" in describing the changes that were intended to be made by section 402(g):

> The conference agreement clarifies the definition of elective deferrals to which the annual limit applies. In the case of an employer that allows employees a one-time election to participate in a contributory defined benefit pension plan with a single mandatory contribution rate or a tax-sheltered annuity program with elective deferrals, neither the election of an employee to participate in the defined benefit plan nor the employee contributions made to the defined benefit plan are to be treated as elective deferrals for purposes of the annual limit. Similarly, if an employee is required to contribute a fixed percentage of compensation to a tax-sheltered annuity as a condition of employment, the contributions are not treated as elective deferrals. This is considered elective deferrals [sic] if the employer and employee enter into temporary employment contracts. The conferees do not intend these examples to constitute the only situations in which contributions are not treated as elective deferrals. The conferees direct the Secretary to provide guidance to employers on other contributions that are not to be treated as elective deferrals.

When the last sentence of section 402(g)(3) providing the rule about one-time irrevocable elections was added in 1988, the committee specifically stated that Congress intended this amendment to have no effect on FICA taxation. Both the

House and the Senate Reports in connection with the 1988 change contain the same language:

Present Law

> Under present law, employer contributions to purchase an annuity contract under a salary reduction agreement (within the meaning of sec. 3121(a)(5)(D)) are considered elective deferrals. The Statement of Managers with respect to the [Tax Reform] Act [of 1986] provides that an employer contribution is not treated as an elective deferral if the contribution is made pursuant to a one-time election to participate in the tax-sheltered annuity <u>even though such contribution would be considered made under a salary reduction agreement under section 3121(a)(5)(D).</u>

Explanation of Provision

> The bill conforms the statutory language to the legislative history by providing that contributions to a tax-sheltered annuity are not considered elective deferrals if the contributions are made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the annuity or are made pursuant to a similar arrangement specified in regulations. <u>The bill does not change the definition of salary reduction agreement for purpose of section 3121(a)(5)(D).</u> The amendment also does not affect the definition of elective deferrals other than with respect to tax-sheltered annuities.

[<u>Emphasis added.</u>) H.R. Rep. 100-795, 100th Cong., 2d Sess. (1988) 145, and Sen. Rep. 100-445, 100th Cong., 2d Sess. (1988) 151. <u>See</u> <u>also</u> Conference Report, H.R. Rep. 100-1104 (1988) 1, 6.

Section 402(g)(3) indicates that a salary reduction agreement described in section 3121(a)(5)(D) is distinct from an elective deferral under section 402(g)(3),and is intended to be a broader term. Section 402(g)(3) indicates that a salary reduction agreement described in section 3121(a)(5)(D) can include a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the agreement. The language “under the salary reduction agreement such contribution is made pursuant to a one-time election at the time of initial eligibility” implies that the employer contributions were under a salary reduction agreement described in section 3121(a)(5)(D) but were not to be treated as elective deferrals. This language in section 402(g)(3) added in 1986, soon after the passage of the 1983 Amendments, supports our position that the taxpayer’s arrangements are salary reduction agreements.

The additional breadth intended to be provided to the definition of salary reduction agreement under section 3121(a)(5)(D) and section 3121(v)(2)(B) is also indicated by the additional parenthetical language contained in these provisions “whether evidenced by a written agreement or otherwise.” This additional language imparting breadth of coverage is not found in the section 403(b) and section 402(g) provisions.

Section 402(g)(3) and its legislative history provide support for the treatment of the contributions made under the salary reduction arrangement to Plan A as FICA wages.

D. Form of Transaction

Under the facts here, the faculty member or other employee receiving a memorandum of appointment is promised a gross salary and the employee in effect authorizes the reduction in that salary if the employee chooses to participate in Plan A. The dispute is whether there is in place a “salary reduction agreement.” The taxpayer’s argument is that because the contributions are required under the terms of the plan to be made from the salaries of the employee, there is no salary reduction agreement. However, under contract law, the document that a participant signs to participate in Plan A is a binding agreement. The taxpayer’s argument that the document is not an agreement is contrary to the plain meaning and common law meaning of the term “agreement.” Under section 3 of the RESTATEMENT OF CONTRACTS (SECOND), an agreement is defined as a manifestation of mutual assent on the part of two or more persons. Comment b to section 3 provides that this manifestation of assent “may be made by words or by any other conduct.” Here, the employee signs the document enrolling in Plan A electing to be covered by the terms of Plan A, and mutual assent of the Employer is evidenced by its setting up Plan A and its role as Administrator of the plan.

There is nothing under the Restatement of Contracts or State C law to suggest that the agreements signed are anything other than binding contractual agreements. Assuming arguendo that the “voluntariness” of the employee’s election has any relevance, the employee who elects to participate in Plan A has made a voluntary election to participate in Plan A and to have his or her salary reduced and contributed to the section 403(b) plan. If the employee had not signed the agreement, the employee would have remained in Plan B and had a different (usually lesser) amount of salary reduction contribution to Plan B, a section 401(a) plan. Thus, even under the taxpayer’s standard of voluntariness, it is logical to treat the documents executed by the employee to participate in Plan A as salary reduction agreements.

If the contributions here were viewed as not made under a salary reduction agreement, then the contributions would simply remain employee contributions subject to FICA taxes.

E. Public Employees' Retirement Board v. Shalala

In Public Employees' Retirement Board v. Shalala, 153 F.3d 1160 (10th Cir. 1998), the court considered whether amounts designated as employee contributions that were "picked up" under section 414(h)(2) were paid under a salary reduction agreement and therefore were wages for FICA tax purposes under section 3121(v)(1)(B). The language in section 3121(v)(1)(B) is similar to the language at issue in section 3121(a)(5)(D). Section 3121(v)(1) provides that "[n]othing in any paragraph of subsection (a) (other than paragraph (1)) shall exclude from the term "wages"...(B) any amount treated as an employer contribution under section 414(h)(2) where the pickup referred to in such section is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise)." Section 3121(a)(5)(D) provides an exception for "any payment made to, or on behalf of, an employee or his beneficiary...under or to an annuity contract described in section 403(b), other than a payment for the purchase of such contract which is made by reason of a salary reduction agreement (whether evidenced by a written instrument or otherwise)...."

The plaintiff in Public Employees' Retirement Board argued that there was no salary reduction agreement because the pick up and the resulting salary reductions were mandated by the New Mexico statutes under which the pension plans were administered. The argument was made that "an individually negotiated contract" is necessary for a salary reduction agreement under a section 414(h)(2) plan. However, the court noted that a salary reduction agreement under the taxpayer's definition could have never qualified as a valid pickup plan under section 414(h)(2). Thus, the court rejected the plaintiff's interpretation, noting that if that interpretation were correct, no section 414(h)(2) pickups would be made pursuant to salary reduction agreements and section 3121(v)(1)(B) would have had no legal effect.

The court stated as follows in deciding that a salary reduction agreement existed:

> Given the IRS's interpretation of "pickup" and given Congress's subsequent endorsement of that interpretation in section 3121(v)(1)(B), a salary reduction agreement necessarily includes any arrangement in which there is a reduction in an employee's salary in exchange for the employer's contribution of the amount of the reduction to a pension plan on the employee's behalf. An "agreement" is not limited to individually negotiated contracts, as the State suggests, but may also refer generally to "a manifestation of mutual assent on the part of two or more persons." RESTATEMENT (SECOND) OF CONTRACTS § 3. Such manifestation of assent

> "may be made by words or by any other conduct." Id. at comment b; see also id. at § 19 (elaborating on conduct as manifestation of assent). Here, an employee's decision to go to work or continue to work as a State employee constitutes conduct manifesting assent to a salary reduction by continuing employment with the State.

153 F.3d at 1166.

Plan A has aspects that are similar to the plan at issue in Public Employees' Retirement Board. However, Plan A is different in that the employee must make an election to participate in Plan A and must sign an individual agreement to participate in Plan A and have his or her salary reduced for the Plan A employee contributions. Thus, the current fact situation represents an even stronger case for the existence of an agreement.

Although the court's rationale included a discussion of the requirement that valid section 414(h)(2) plans are mandatory in nature, there is no provision within section 3121 indicating the similar language in section 3121(a)(5)(D) should be interpreted differently. Furthermore, in the case of section 3121(a)(5)(D), the legislative history and case law have stressed the distinction between salary reduction contributions and salary supplement contributions in Rev. Rul. 65-208 that is, in effect, consistent with Public Employees. Of particular significance is the fact that this identical clause "salary reduction agreement (whether evidenced by a written instrument or otherwise)" is found only in sections 3121(a)(5)(D) and 3121(v)(1)(B).

The Public Employees case is consistent with the salary reduction and salary supplement dichotomy found in the FICA taxation of section 403(b) plans, in that the case would seem to hold that salary reduction contributions that were picked up under section 414(h)(2) would be subject to FICA taxes. Conversely, if the section 414(h)(2) contributions had been made pursuant to a salary supplement plan, rather than a salary reduction plan, the contributions would presumably be employer contributions that would not be subject to FICA taxation.

In light of the above, we have concluded the contributions to Plan A at issue here are being made pursuant to salary reduction agreements and therefore are includible in wages for FICA tax purposes under section 3121(a)(5)(D). Pursuant to the analysis above, if the contributions to Plan A from the employees' salaries were instead viewed as mandatory contributions not made pursuant to a salary reduction agreement (as the taxpayer has argued), the contributions would still be wages for FICA tax purposes (as employee contributions to the plan).

SUMMARY

In light of the above, we have concluded the contributions at issue here are being made pursuant to salary reduction agreements and are includible in wages for FICA tax purposes. Therefore, any refund claims for FICA taxes paid on the salary reduction contributions to Plan A should be denied.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

No refunds should be granted to the Employer with respect to this issue. All such claims related to Plan A should be denied. In addition, we recommend [redacted]

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