Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200951032**
Release Date: 12/18/2009

CC:TEGE:EOEG:ET2:DMParkinson
POSTU-128398-09

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 3121.16-02

date: September 08, 2009

to:

from:

(Tax Exempt & Government Entities)

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subject: Code Section 3121(v) Transition Benefits

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

LEGEND

Taxpayer =
Plan =
State =
Case 1 =

Case 2 =

ISSUES

1. What effect do the terms of a collective bargaining agreement entered into between the Plan and the Taxpayer's employees have in determining whether the Plan constitutes an agreement in existence on March 24, 1983, within the meaning of Employment Tax Regulation (Regulation) § 31.3121(v)(2)-2(b)(6)?

2. What effect does informal guidance provided by the Social Security Administration (SSA) concerning the application of the transition rule of Section 324(d)(4) of the Social Security Amendments of 1983 (SSA 83) (P.L. 98-21, as amended by section 2662(f)(3) of P.L. 98-369) have in determining the Federal Insurance Contributions Act (FICA) tax treatment of amounts deferred under the Plan?

3. What effect do decisions of the State Supreme Court have in determining the FICA tax treatment of amounts deferred under the Plan?

CONCLUSIONS

1. The terms of the collective bargaining agreement are relevant in determining whether a nonqualified deferred compensation plan constitutes a March 24, 1983 agreement within the meaning of Regulation § 31.3121(v)(2)-2(b)(6).

2. Letters from the Social Security Administration are not determinative of the FICA tax treatment of amounts deferred under the Plan.

3. The State Supreme Court cases cited by the Taxpayer are not dispositive of the FICA tax treatment of amounts deferred under the Plan.

FACTS

On March 24, 1983, the Taxpayer maintained the Plan, a nonqualified deferred compensation retirement arrangement. This Plan is still currently maintained by the Taxpayer. The purpose of the Plan was to encourage eligible certificated employees who were considering retirement to accelerate their retirement plans. Under the terms of the Plan any certificated full-time employee that had attained age 55 and was not older than 64 and had at least 20 years of creditable service as a full-time employee was entitled to participate in the Plan and receive a deferred compensation benefit upon written application to and approval of the Superintendent of Schools and the Board of Education.

The collective bargaining agreement provides in part:

> Full-time certificated employees, upon written application and approval of the Superintendent of Schools and the Board of Education may participate in the Plan.

A plan subsection is entitled “Program Eligibility Requirement and Provisions.” This subsection lists eight conditions which must be satisfied by an employee in order to participate in the Plan. The conditions include:

> Applications must be made in writing on the appropriate form … by February 15 of the school year prior to the school year in which the certificated employee wishes to discontinue full-time employment.

> The certificated employee must be at least fifty-five (55) and no more than sixty-four (64) years of age as of the separation date ….
>
> The certificated employee must have at least twenty (20) creditable years of service … as a full-time employee ….
>
> Certificated employees participating in the program cannot return to full-time or part-time regular employment [for the Taxpayer] … at a later date.

The Taxpayer asserts that its "full time certificated employees who were employed by the [Taxpayer] … on March 24, 1983, were eligible participants of the Plan on such date."

The Taxpayer provided two letters from the SSA.

The first letter from the SSA, dated March 19, 1984, is addressed to a U.S. Congressman in response to a request on behalf of the Taxpayer concerning the Social Security wage status of payments under the Plan. With respect to the question of whether Plan payments are made under an exempt governmental deferred compensation plan as defined in Code section 3121(v)(3) the letter states: "We are unable to give an authoritative response to the question until the IRS publishes regulations interpreting this provision of the Code." The letter then raises various legislative and regulatory possibilities.

The second letter from the SSA, dated March 25, 1985, provides that payments made after 1983 based on service performed before 1984 under a March 24, 1983 agreement between the Plan and an individual who is under the Plan will be excluded from wages to the extent that such payments were excluded from wages prior to the enactment of Code section 3121(v). The SSA's letter also notes that payments under the Plan may not be deferred compensation, however this is a "tentative view based on informal discussions with the Internal Revenue Service". The letter is further caveated to provide that a "formal determination on these issues must be made by [the] IRS."

LAW AND ANALYSIS

1. What affect do the terms of a collective bargaining agreement entered into between the Plan and the Taxpayer's employees have in determining whether the Plan constitutes an agreement in existence on March 24, 1983, within the meaning of Regulation § 31.3121(v)(2)-2(b)(6)?

The terms of a collective bargaining agreement are relevant in determining FICA tax liability under Code section 3121(v)(2). By way of background, section 3121(v)(2) was enacted by SSA 83. In those Amendments, Congress repealed the general FICA tax exclusion for retirement payments provided in Code sections 3121(a)(2)(A), (a)(3), and

(a)(13)(A)(iii). Under Code section 3121(v)(2)(A), any amount deferred under a nonqualified deferred compensation plan is taken into account as wages for FICA tax purposes as of the later of (i) when the services are performed, or (ii) when there is no substantial risk of forfeiture of the rights to such amount.
The retirement pay exclusions provided under the law as in effect on April 19, 1983, (the day before the enactment of SSA 83) applied to retirement payments prior to December 31, 1983. The transition rules in Regulation § 31.3121(v)(2)-2 are applicable on and after January 1, 2000. These rules are used to determine whether amounts deferred and payments made are taxed under Code section 3121(v)(2) or are eligible for the favorable treatment afforded transition benefits.

The transition rules provide that "transition benefits" paid pursuant to a "March 24, 1983 agreement" are not subject to FICA taxes provided that payments under the agreement would have met one of the retirement pay exclusions in effect on April 19, 1983. Regulation § 31.3121(v)(2)-2(b)(6) defines a March 24, 1983, agreement as an agreement in existence on March 24, 1983, between an individual and a nonqualified deferred compensation plan within the meaning of Regulation § 31.3121(v)(2)-1(b). Transition benefits are benefits paid after December 31, 1983, attributable to services rendered before January 1, 1984.

The terms of the collective bargaining agreement may be useful in determining the existence of a nonqualified deferred compensation plan within the meaning of Regulation § 31.3121(v)(2)-1(b). Additionally, the terms of a collective bargaining agreement provide the factual background needed to determine whether the Plan is a March 24, 1983 agreement and whether benefits under the Plan are attributable to "specific years of service" within the meaning of Regulation § 31.3121(v)(2)-2(d). Ultimately however, the collective bargaining agreement and other facts and circumstances pertaining to the deferred compensation arrangement must be evaluated using the rules and standards in the Regulations in order to arrive at the proper FICA tax treatment of amounts deferred.

The Plan is a nonqualified deferred compensation plan within the meaning of Regulation § 31.3121(v)(2)-1(b)(1). The Plan provides for deferred compensation benefits to employees who satisfy certain conditions.

The Taxpayer maintains that all employees under the collective bargaining agreement are individual parties to the March 24, 1983 agreement even if the employees had not met the age and service requirements to participate in the Plan as of March 24, 1983. Specifically, the Taxpayer states:

> In accordance with this collective bargaining agreement, all full time certificated employees … were eligible to participate in the … Plan on March 24, 1983, even though the employee must satisfy stated conditions to receive a future benefit under the … Plan …."

We disagree. The Plan is a March 24, 1983 agreement for purposes of the transition rules of Code section 3121(v)(2). However, Regulation § 31.3121(v)(2)-2(b)(5) provides that an individual is a "party to a March 24, 1983 agreement" if the individual was "eligible to participate in a March 24, 1983 agreement under the terms of the agreement on March 24, 1983." This means that employees who have not met the Plan's age and service requirements as of March 24, 1983, are not parties to a March 24, 1983 agreement, even if they may satisfy those requirements at some later date. The terms of the Plan on March 24, 1983, indicate that an employee is eligible to participate in the Plan on the date the employee becomes a full-time certificated employee. However, mere eligibility to participate in the Plan does not equate to being a "party to a March 24, 1983 agreement" which pursuant to the Plan's terms requires the satisfaction of certain age and service criteria.

The Taxpayer states that "there is no requirement that the covered employees must have actually accrued benefits under the Plan as of March 24, 1983, to qualify for the transition rule." We agree. Regulation § 31.3121(v)(2)-2(b)(6) provides that an individual party to a March 24, 1983 agreement means an individual who was eligible to participate in a March 24, 1983 agreement "even if the individual has not accrued any benefits under the plan by March 24, 1983, and regardless of whether the individual has taken any specific action to become a party to the agreement." However, the Regulations do require that an individual must be eligible to participate in a March 24, 1983 agreement under the terms of the agreement on March 24, 1983. Individuals who become eligible to participate after March 24, 1983, are not individual parties to a March 24, 1983 agreement. See Regulation § 31.3121(v)(2)-2(b)(5).

In conclusion, the terms of a collective bargaining agreement between the Plan and the Taxpayer's employees providing for deferred compensation benefits to employees who have satisfied certain conditions are relevant to establishing the facts and circumstances of the deferred compensation arrangement. However, the Regulations at § 31.3121(v)(2)-2(b)(6), and not the collective bargaining agreement, are determinative of whether employees are "individual parties to a March 24, 1983 agreement."

2. What affect does informal guidance provided by the SSA concerning the application of the transition rule of Section 324(d)(4) of the Social Security Amendments of 1983 (SSA 83) (P.L. 98-21, as amended by section 2662(f)(3) of P.L. 98-369) have in determining the FICA tax treatment of amounts deferred under the Plan?

The Taxpayer asserts that letters given to it by the SSA in 1984 and 1985 discussing Code section 3121(v) are somehow determinative of current FICA tax liability. The taxpayer questions whether the IRS "could overturn original guidance provided by the Social Security Administration that the transition rule of Section 324(d)(4) of the Social Security Act Amendments of 1983 (P.L. 98-21, as amended by P.L. 98-369, § 2662(f)(2)) applied in determining the taxpayer portion of benefits paid under the plan after 1983."

The letters from the SSA are not rulings, do not purport to be rulings, and do not purport to bind the IRS in any way. The amendments made by section 324 of SSA 83 are amendments to the Code. The IRS is the agency responsible for administering the Code. According to the Memorandum of Understanding between the IRS and the SSA for State and Local Government Compliance Issues (MOU), the IRS is responsible for:

- Administering the Federal Insurance Contributions Act (FICA),including the mandatory Social Security and Medicare provisions concerning services performed by state and local government employees;
- Assuring that there is proper reporting and collection of Social Security and Medicare taxes by state and local governments under the FICA through examination and other compliance programs; and
- Interpreting the FICA provisions applicable to state and local governments through published guidance, e.g., Regulations, revenue rulings, and revenue procedures, and through non-precedential advice to taxpayers and IRS personnel, e.g., private letter rulings and field directives.

Prior to 1987, the state Social Security Administrators were responsible for reporting covered wages to SSA, collecting the Social Security and Medicare contributions from public employers, and depositing those amounts to the Social Security Trust Funds. Beginning January 1, 1987, state and local government employers became responsible for the reporting and payment of Social Security and Medicare taxes directly to the IRS. Thus, for wages paid after January 1, 1987, neither SSA, nor the State Social Security Administrators have responsibility for collecting and depositing Social Security and Medicare contributions from public employers. This case concerns only wages paid in years after January 1, 1987, so SSA has no responsibility for collecting the Social Security and Medicare contributions with respect to the wages at issue in this case.

The letter from the SSA that the Taxpayer purports to rely on states that “payments made after 1983 based on services performed before 1985 under an agreement in existence on March 24, 1983, between the plan and an individual who is under the plan will be excluded from wages for Social Security purposes to the extent such payments [would have been excluded from wages under the Social Security Act as in effect prior to January 1, 1984].”

The statement in the SSA letter is consistent with the amendment made to section 3121(v) by the SSA 83 and the Deficit Reduction Act of 1984 (DEFRA ’84). The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 pertaining to these amendments contains the following similar statement: “… the Act extends the grandfather rule to apply to agreements in existence on March 24, 1983, between an individual and a plan or employer, if the agreement provided for making payments upon retirement which would have been excluded from tax under prior law. Thus, under the Act, if such an agreement was in existence on that date, prior law is applicable with respect to remuneration attributable to service performed before January 1, 1984, for FICA purposes ….”

Although the statement in the SSA letter is correct and consistent with amendments made by the SSA 83 and DEFRA 84, it does not opine on the facts and circumstances necessary for there to be an "agreement in existence on March 24, 1983 between an individual and a plan." Neither the statute itself nor the General Explanation or other legislative history contains any guidance on this point. The Taxpayer urges that such an agreement exists between a nonqualified deferred compensation plan in existence on March 24, 1983, and all employees who had satisfied the Plan's criteria to participate in such Plan on or before March 24, 1983, as well as any employees who satisfied the Plan's criteria to become participants on any date after March 24, 1983. However, Regulation § 31.3121(v)(2)-2(b)(6) states that "an individual who becomes eligible to participate in a March 24, 1983 agreement after March 24, 1983, is not an individual party to a March 24,1983 agreement."

Because neither the statue nor its legislative history describe the specific circumstances when there is "an agreement in existence on March 24, 1983 between and individual and a plan," the IRS and the Department of Treasury are responsible for promulgating guidance to interpret any ambiguity in the statute. In the Code, Congress expressly delegated authority to the Secretary of the Treasury to adopt regulations to fill in gaps in the statute.

§ 7805. Rules and regulations

> (a) Authorization
>
> Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

The Regulation at § 31.3121(v)(2)-2 represents a valid exercise of the Treasury Department's authority to promulgate guidance interpreting Code provisions. Regulations promulgated by an agency charged with administering a statute are entitled to deference as long as the regulations are based upon a permissible construction of the statute. See Chevron U.S.A. Inc. v. National Resources Council, Inc. 467 U.S. 837 (1984). Any suggestion that informal letters from the SSA addressing Code provisions should somehow be accorded greater deference than the regulations promulgated by the Treasury Department is without merit.

Internal Revenue Manual

The Taxpayer also asserts that section 4.23.5.1(4) of the Internal Revenue Manual (IRM) has not been followed in this case. IRM section 4.23.5.1 is an Overview of the Technical Guidelines for Employment Tax Issues. IRM section 4.23.5.1.(2) provides:

> [T]he Internal Revenue Service administers the employment taxes imposed by Chapters 21 through 24 of the Internal Revenue Code …. An important phase of administration of employment taxes … is interpreting the sections of the Code applicable to these taxes…. The Service refers all questions for eligibility for and computation of social security benefits to the Social Security Administration.

This IRM provision merely reflects the division of responsibilities between the IRS and the SSA. As set forth in more detail in the MOU between the IRS and SSA, the IRS has responsibility for the Social Security and Medicare taxation provisions of the Code, and SSA has responsibility for determining issues related to Social Security coverage, such as whether individuals are eligible to receive Social Security benefits. Eligibility for Social Security benefits is based on calendar quarters of covered employment. SSA maintains earnings records for individuals who work in covered employment in order to determine whether such individuals have accrued sufficient quarters of covered employment to qualify for Social Security benefits. However, the IRS, and not the SSA, is responsible for assuring that there is proper reporting and collection of Social Security and Medicare taxes by state and local governments under the FICA through examination and other compliance programs.

<u>General Counsel Memorandum 36568</u>

The Taxpayer cites General Counsel Memorandum (Memorandum) 36568, February 4, 1976, for the proposition that the IRS does not have jurisdiction over contributions under a Section 218 Agreement. The Memorandum provides in part:

> Section 218 of the Social Security Act provides that a state may enter into an agreement with H.E.W. to have Social Security coverage extended to its employees and employees of its political subdivisions. … Whether or not a share of the contribution may be collected from the employee is determined by State law. Contributions, whether paid by the employer or employee, under a 218 agreement are not a tax under the Federal Insurance Contributions Act administered by the Internal Revenue Service.

We note that this Memorandum was issued on February 4, 1976. For the years at issue in this case, the Social Security and Medicare contributions ***are*** taxes imposed under section 3121(v)(2) of the Code, and the IRS is responsible for administering the Code. Effective with respect to wages paid after December 31, 1986, section 9002 of the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509) amended the Social Security Act and the Code, to provide that State and local government employers were made subject to the same rules for depositing payroll taxes as those applicable to private-sector employees. House Conference Report No. 99-1012 provides that the change "removes from State governments the intermediary role of collecting social security taxes from local governments, and relieves State governments form liability for verifying and depositing such taxes." Therefore, the Memorandum has been superseded by changes in the law.

3. What affect do decisions of the State Supreme Court have in determining the FICA tax treatment of amounts deferred under the Plan?

In State Supreme Court Case 1, retirees sought a declaratory judgment that retiring State employees had a constitutional right to have the amount of a lump sum payment they received for accumulated but unused vacation and sick leave included for purposes of calculating a pension benefit. The court held that the State could not discontinue its practice of including the lump-sum payments in final average monthly salary because the retirees had a vested contractual right to have the payments included.

In State Supreme Court Case 2, firefighters filed a class action suit against a city when a supplemental pension plan was eliminated by the city. The firefighters maintained that the elimination violated the contract clause of the U.S. Constitution. Article 1, § 10, cl. 1 of the U.S. Constitution states that no state shall pass any law impairing the obligation of contracts. The court held that the supplemental benefit plan was a pension plan. The court also held that pursuant to State law the pension vested on an individual's acceptance of employment and that the city's elimination of the plan violated the U.S. Constitution. (Emphasis added).

The fact that deferred compensation benefits are protected, and that certain pension benefits vest upon acceptance and commencement of employment under state law is not determinative of the FICA tax treatment of nonqualified deferred compensation plan transition benefit payments under Code section 3121(v)(2) and the regulations thereunder. Nonqualified deferred compensation is subject to FICA tax under section 3121(v)(2) as of the later of (i) when the services are performed, or (ii) when there is no substantial risk of forfeiture, and when such a risk ceases to exist is determined based on the rules of section 83 and the regulations thereunder. Regulation § 31.3121(v)(2)-1(e)(3).

The question presented is whether employees who did not meet the age and service requirements necessary to participate in the Plan as of March 24, 1983, can still be considered "individual parties to a March 24, 1983 agreement" within the meaning of Regulation § 31.3121(v)(2)-2(b)(5). If the answer to that question is yes, then those employees can benefit from the transition rule which provides that benefits attributable to service performed prior to 1984 are not subject to FICA tax. The answer to this question is governed by the Internal Revenue Code and its implementing regulations. State court cases concerning when employees have a vested interest in pension benefits do not control the answer to this question.

The Supremacy Clause of Article VI of the United States Constitution provides, in part, that federal laws shall be the supreme law of the land. Supreme Court cases have established that state law is preempted under the Supremacy Clause by federal law where federal law regulates conduct in a field that Congress intended the federal government to occupy exclusively. Such an intent may be inferred from a "scheme of federal regulation … so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it." Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 231 (1947).

The Social Security Act is a comprehensive scheme of federal regulation. Title VIII of the Social Security Act of 1935 is entitled Taxes with Respect to Employment. Section 807(a) provides: "The taxes imposed by this title shall be collected by the Bureau of the Internal Revenue under the direction of the Secretary of the Treasury and shall be paid into the Treasury of the United State as internal-revenue collections". Section 808 provides: "The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall make and publish rules and regulations for the enforcement of this title."

The actions of Congress indicate that jurisdiction and responsibility for the Code's FICA taxing provisions relating to the Social Security Act lie solely with the Internal Revenue Service and the Department of the Treasury. State court decisions are not controlling with respect to issues concerning the FICA tax treatment of nonqualified deferred compensation.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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

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