

DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224

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MEMORANDUM FOR ALLEN P. JONES

DIRECTOR, FEDERAL, STATE, AND LOCAL

GOVERNMENTS

FROM: Mary Oppenheimer by Jerry E. Holmes

Assistant Chief Counsel

(Exempt Organizations/Employment Tax/Government Entities)

Office of the Division Counsel/ Associate Chief Counsel (Tax Exempt and Government Entities) CC:TEGE

SUBJECT: FICA taxation of State Section 403(b) Plan

This Chief Counsel Advice responds to your request for assistance. Please distribute this memorandum to affected field offices as you deem appropriate. In accordance with Internal Revenue Code section 6110(k)(3), this Chief Counsel advice should not be cited as precedent.

LEGEND:
State C =
Plan A =
State C Statutes <u>m</u> =
Plan B =
State C Statute <u>n</u> =
State C Statute p =
Employer =
<u>r</u> =
<u>s</u> =

<u>t</u> =

<u>u</u> =

v =

Agency F =

Governing Body Z =

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: The 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. Any refund claims for FICA taxes paid with respect to salary reduction contributions to Plan A should be denied.

FACTS: Employees of the Employer are 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 two separate and mutually exclusive retirement programs for employees of public educational institutions and certain related agencies. These two programs are Plan B and Plan A. 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 r percent.

Plan A is intended to be a section 403(b) plan. Only certain categories of workers are eligible to participate in Plan A. Plan A, including the participation rules and contribution requirements, is provided for by statute (State C Statutes m).

Employees who are eligible to participate in Plan A are initially automatically covered in Plan B. To participate in Plan A, the employee must make an election to participate before the \underline{v} day after first becoming eligible to participate in Plan A. An employee who does not elect to participate in Plan A is considered to have chosen to continue membership in Plan B. An employee can cease participation in Plan A only upon death, retirement, or termination of employment at all institutions of higher education. The taxpayer has indicated the election to participate in Plan A and to have salary reduced is irrevocable, although the agreement providing for the salary reduction says that the salary reduction will continue "until revoked by either party." Each participant is currently required to make salary reduction contributions of \underline{s} percent of compensation to Plan A (a different percentage amount than the contribution from the employee's salary to Plan B), and State C makes additional contributions equal to \underline{t} or \underline{u} percent of the employee's compensation depending upon the date of hire.

When an employee elected to participate in Plan A, he or she executed an "agreement" with the Employer. Under the "agreement," the employee stated that he or she requested that the [Employer] pay premiums for purchase of an annuity or investment contract in lieu of a portion of the compensation otherwise payable directly to the employee for the calendar year and thereafter until revoked by either party. An employee electing to participate in Plan A authorized the Employer to "[r]educe my gross monthly salary at the rate of <u>s</u> percent per month beginning the first day of ... and each month thereafter for so long as I [am] employed by the [Employer] and am participating in the [Plan A] or until revoked by either party."

The document specifically provided that it was an amendment to the employment agreement between the Employer and the employee. The "agreement" also stated that the employee "release[s] all rights, present and future, to receive payment in any form of amounts agreed upon as stated above except, (1) the right of my estate upon my death while in the employ, or (2) the right personally upon termination of my employment by reason other than my death to receive all or any part of the amount herein specified for which I have already rendered services but which has not been transferred to the 403(b) carrier."

It appears that at some date a revision was made in the agreement form and a new document has been used. The new document is entitled

This document provides that the employee certifies that he or she has never been previously eligible for Plan A. It states that the employer is hereby notified that the employee has "elected to participate in [Plan A] to be effective [on a date selected] in lieu of [Plan B]". The form also provides the conditions under which the employee could become a member of Plan B in the future and also the conditions under which membership in Plan A is terminated. The employee designates the carrier for his or her Plan A participation. The form is signed by the employee and signed by an authorized representative of the Employer.

State C statutes characterize the documents executed by employees and the Employer as salary reduction agreements. State C Statute n, is titled

State C Statute \underline{n} provides that a participant in Plan A and either the employing institution of higher education or, as applicable, the Agency F, acting through its governing board,

State C Statute <u>p</u> provides that the salary reduction agreement is "irrevocable" until the earlier of (1) the date the participant ceases participation in Plan A or (2) the date that it is determined by the IRS or legislation that the contributions of participants to Plan A are elective deferrals within the meaning of section 402.

Faculty appointments to the Employer are subject to the rules and regulations of the Governing Body Z. The rules and regulations of Governing Body Z provide that the terms and conditions of employment of all faculty members shall be embodied in a in the format and with content specified in standard forms issued by the Employer. These standard forms contain spaces that require entries for the academic title and salary of the faculty member. The salary specified in the forms is the gross salary for the indicated budget period only and is subject to deductions required by state and federal law and, if permitted by law, other deductions that the employee authorizes. The forms are signed by a representative of the Employer. The employee also signs the form indicating that he or she accepts the appointment.

State C statutes provide that a state agency may not make a deduction from the compensation paid to an officer or employee whose compensation is paid in full or in part from state funds unless the deduction is authorized by law. For this purpose, state agency is defined to include a State C institution of higher education. State C statutes also provide that the state shall withhold money from salaries and wages paid to state officers and employees in accordance with applicable federal law, including federal law relating to withholding for purposes of the federal income tax. The statutes also provide that the state shall make any required employer contributions in accordance with applicable federal law.

Vesting of the State C matching contributions to Plan A occurs one year and one day following the effective date of Plan A participation. In contrast, a participant is immediately vested in Plan A contributions that are made by salary reduction. Until an individual vests in the State C matching contributions, the salary reduction contributions and State matching contributions are invested separately. If an individual does not vest in the State C matching contributions, such contributions must be refunded by Plan A to State C.

The Employer requested a ruling concerning the FICA tax status of the salary reduction contributions to Plan A and later withdrew the ruling request upon being advised that an adverse opinion would be issued. The Employer has also filed claims for FICA tax refunds for FICA taxes paid with respect to these contributions. Numerous other State C educational and other entities also have employees who can elect to participate in Plan A, but are otherwise covered by Plan B.

ANALYSIS

BACKGROUND

The FICA taxation of contributions to section 403(b) plans 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 section 403(b) contributions are excludable from gross income, such contributions are subject to FICA taxes if they are made by reason of a salary reduction agreement.

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. The ruling also drew a distinction between salary reduction contributions and contributions that were made from the employer's own funds. 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.

Rev. Rul. 65-208 also introduced another concept that has survived to the current day: the interpretation of terms for income tax purposes and for FICA tax purposes is

different. There is a strong policy rationale for the differing interpretations. The interpretation of terms for purposes of section 403(b) is driven by a different purpose than the interpretation of terms for purposes of section 3121(a). Section 403(b) provides an income tax incentive to set aside funds for retirement through salary reduction contributions by excluding section 403(b) contributions from gross income at the time of deferral. However, if these contributions from the employee's salary were excluded from FICA wages, the employee would lose social security coverage and thus potential social security retirement benefits by making the contributions to section 403(b) plans. It would seem to contravene the purpose of social security (to provide a retirement income base for retirees) for a contribution from the employee's salary for the employee's retirement to reduce both social security funding and the social security coverage of the employee. However, the income tax goal of encouraging section 403(b) plans to provide for employees' retirement can be reconciled with the similar social security goal of providing funding and coverage for employees' retirement if different interpretations under the FICA can apply and result in a broader interpretation of "wages" than "income."

Rowan Companies

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 conflicts 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.

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 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 <u>Public Employees' Retirement Board v. Shalala</u>, 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 maintains 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".

However, 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).

There is an element of ambiguity in whether the description in the conference report is intended to be the exclusive definition of salary reduction agreement and what is the meaning of the term "individually negotiated." The conferees merely stated that individually negotiated employment arrangements would be treated as salary reduction agreements. They did not say that no other type of arrangement could constitute a salary reduction agreement. The final sentence of the cited language simply supports the idea that receipt by only one individual of employer contributions does not definitively establish the individual's salary is being reduced. In other words, the employer could be making employer contributions for the employee without necessarily

arising from an agreement of the employer to make any contributions in lieu of salary (i.e., they could be salary supplement contributions).

Even if individual negotiation were a requirement, in Plan A, each individual must <u>elect</u> to participate in the section 403(b) plan. Whenever someone files such an election there has been an individual decision as to the terms of that employee's employment contract. The individual is choosing between two retirement plans and two different levels of salary reduction.

The second part of the 1983 Amendments that is of importance in this context is the amendment made to overturn the broad rationale of <u>Rowan</u>. This provision, which is referred to as the "anti-<u>Rowan</u> amendment" is codified in the penultimate sentence of section 3121(a). The anti-<u>Rowan</u> 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 terms can be interpreted differently for FICA than for income tax purposes was, in effect, incorporated into the statute by the anti-Rowan amendment.

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-raising 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. 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.

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 at

the heart 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.

Summary

For 36 years, a distinction has existed for FICA tax purposes between salary reduction agreement contributions and salary supplement contributions made to section 403(b) plans. This distinction has survived an adverse Supreme Court decision and years of contentious litigation, and has been supported by Congress at crucial junctures in order to protect the social security revenue base. This established distinction supports the position that the contributions made to Plan A under the salary reduction arrangements authorized by State C statutes are made under "salary reduction agreements" for FICA tax purposes and are therefore wages for FICA tax purposes..

DISTINCTION BETWEEN CONTRIBUTIONS MADE BY SALARY REDUCTION AND CONTRIBUTIONS MADE BY SALARY DEDUCTION

The taxpayer has argued that these contributions are mandatory employee contributions 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 contributions made by salary deduction rather than salary reduction for FICA tax purposes. As salary deduction contributions, the contributions would be employee contributions to the section 403(b) plan and 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 made by salary deduction (rather than salary reduction), the contributions would also be subject to FICA taxes.

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 <u>University of North Dakota v. United States</u>, 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.

Rev. Rul. 70-582, 1970-2 C.B. 95, illustrates that the salary reduction and salary deduction alternative can also apply in the context of section 403(b) plans. Thus, these plans could also have taxable employee contributions if the contributions to the plan are made by salary deduction rather than salary reduction.

SECTION 403(b) INTERPRETATIONS OF SALARY REDUCTION AGREEMENT:

1. "Salary reduction agreement" language 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 depend upon whether a salary reduction agreement exists. See section 403(b)(1)(E) and section 402(g)(3)(C).

As noted, the interpretation of terms for purposes of income taxes has differed from the interpretation of the terms for FICA purposes because of the different purposes of the provisions. The difference in interpretation of the term "salary reduction agreement" 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." <u>Gozlon-Peretz v. United States</u>, 498 U.S. 395, 404 (1991), quoting <u>Russello v. United States</u>, 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). The language in section 402(g)(3) indicates that the agreement in the instant case could be a salary reduction agreement, but not an elective deferral. 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 section 402(g)(3) and our interpretation 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 word "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 even though such contribution would be considered made under a salary reduction agreement under section 3121(a)(5)(D).

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. The bill does not change the definition of salary reduction agreement for purpose of section 3121(a)(5)(D). The amendment also does not affect the definition of elective deferrals other than with respect to tax-sheltered annuities.

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

Thus, 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. Also, the legislative history cited above strongly supports the idea that a one-time election can still be a salary reduction agreement under section 3121(a)(5)(D).

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.

In summary, the reference in section 402(g) indicates that a one-time irrevocable election can be a salary reduction agreement under section 3121(a)(5)(D), although this election would apparently not be a salary reduction agreement for the limited purpose of section 403(b)(12). However, the application of each of these provisions is limited to the purposes of the particular paragraph (either 402(g)(3) or section 403(b)(12)) in which they are contained. To the extent either provision has any effect, the specific reference in section 402(g)(3) to section 3121(a)(5)(D) implies that section 402(g)(3) should be given greater weight.

To the extent the income tax provisions have significance for FICA tax purposes, section 402(g)(3) and its legislative history provide support for the treatment of the salary reduction contributions to Plan A as FICA wages.

2. The Definition of Salary reduction agreement in Rev. Rul. 2000-35

¹ Another possible interpretation would be that this flush language at the end of 402(g)(3) is indicating that this type of "salary reduction agreement" is not a salary reduction agreement within the meaning of section 3121(a)(5)(D). This seems like a strained interpretation in that it presumes that Congress intended to use salary reduction agreement as having two meanings within the same paragraph (402(g)(3)). Also, this alternative interpretation contradicts the legislative history discussed above.

In Rev. Rul. 2000-35, 2000-31 I.R.B. 138, the Service considered whether certain contributions to a section 403(b) plan (informally known as contributions made under a "negative election") would be considered made pursuant to a salary reduction agreement described in section 403(b). The ruling concludes with the following holding: "Where, as in this case, a newly hired or current employee has an effective opportunity to elect to receive an amount in cash or have that amount contributed by the employer to an annuity contract described in § 403(b), those contributions made on the employee's behalf to the annuity contract in lieu of receipt of cash compensation will not fail to be considered to be made under a salary reduction agreement merely because they are made pursuant to an arrangement under which, in any case in which an employee does not affirmatively elect to receive cash, the employee's compensation is reduced by a fixed percentage and that amount is contributed on the employee's behalf to the annuity contract."

Rev. Rul. 2000-35 provides that contributions to purchase annuity contracts under § 403(b) may be made either pursuant to a salary reduction agreement or not pursuant to a salary reduction agreement. Contributions made pursuant to a salary reduction agreement are subject to different requirements than are contributions not made pursuant to a salary reduction agreement. (See, for example, §§ 403(b)(1)(E), 403(b)(7)(A)(ii), 403(b)(11) and 403(b)(12).) In general, a contribution is not treated as 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 agreement. See §§ 402(g)(3)(C) and 403(b)(12).

The revenue ruling also notes a legislative change for purposes of section 403(b). Section 1450(a) of the Small Business Job Protection Act of 1996 provides that for purposes of section 403(b), the frequency that an individual is permitted to make a salary reduction agreement, the salary to which such an agreement may apply, and the ability to revoke such an agreement shall be determined under the rules applicable to cash or deferred elections under section 401(k). This provision is effective after 1995.

Section 1.401(k)-1(a)(3)(i) defines a cash or deferred election as any election (or modification of an earlier election) by an employee to have the employer either provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available or contribute an amount to a trust (or provide an accrual or other benefit) under a plan deferring the receipt of compensation. Section 1.401(k)-1(a)(3)(iv) provides that a cash or deferred election does not include a one-time irrevocable election, made at the time an employee commences employment with the employer or upon the employee's first becoming eligible under any plan of the employer, to have contributions made by the employer on the employee's behalf to the plan (or to any other plan of the employer) equal to a specified amount or percentage of the employee's compensation. Section 1.401(k)-1(g)(3) defines elective contributions as employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement.

The ruling further provides as follows:

In this case, ... the employee has a reasonable period before the cash is currently available to elect to receive the cash in lieu of having it contributed towards the purchase of an annuity contract. Thus, the employee has an effective opportunity to elect to receive cash or have a contribution made towards the purchase of an annuity contract....Finally, compensation reduction contributions made under the plan are not contributions made pursuant to a one-time irrevocable election because the employee can change the election in the future, Consequently, the compensation reduction contributions under [the plan at issue in the revenue ruling] as amended are contributions made pursuant to a salary reduction agreement described in § 403(b).

Rev. Rul. 2000-35 is an income tax ruling and thus should not be controlling with respect to what constitutes a salary reduction agreement for FICA tax purposes. Consistent with the legislative history and <u>Public Employees' Retirement Board</u>, a contribution made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the section 403(b) plan agreement or a salary reduction contribution that is a condition of employment <u>is</u> a salary reduction agreement for purposes of section 3121(a)(5)(D). The difference between salary reduction contributions and salary supplement contributions has been the decisive factor in FICA taxation since the publication of Rev. Rul. 65-208. The legislative history in the Background section and the 1988 change to section 402(g)(2)(C) offer support for having an interpretation of salary reduction agreement for FICA purposes that is different from the interpretation for income tax purposes.

This revenue ruling was never cited by the taxpayer or used as support for its requested ruling. We agree that it is not controlling here and is yet another manifestation of the distinction between interpretations of terms for FICA purposes and interpretations of terms for income tax purposes that originated in Rev. Rul. 65-208.

FORM OF TRANSACTION

There does not appear to be a dispute that the employees are undergoing a salary reduction with respect to their contributions to Plan A. The faculty member or other employee receiving a memorandum of appointment is promised a gross salary and the employee authorizes the reduction in that salary for contributions to Plan A. The dispute is whether there is in place a "salary reduction agreement." Under contract law, the documents that the participants sign to have their salaries reduced for contributions to Plan A are binding agreements. 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

authorizing the reduction in salary and a representative of the Employer signs the document.

State C Statute <u>n</u> has cast the transactions in the form of "salary reduction agreements." 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. The taxpayer seeks to disavow both the form <u>and the substance</u> of the transaction by arguing that the transaction is something other than a salary reduction agreement. <u>See Commissioner v. National Alfalfa Dehydrating and Milling Co.</u>, 417 U.S. 134, 149 (1974), in which the Supreme Court stated that "[w]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, ... and may not enjoy the benefit of some other route he might have chosen to follow but did not."

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 sign the agreement 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, 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 respect the specific characterization of the agreement made in the State C Statutes: "Salary Reduction Agreement."

OTHER FICA AUTHORITIES

Public Employees' Retirement Board v. Shalala

In <u>Public Employees' Retirement Board v. Shalala</u>, 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 taxpayer in <u>Public Employees' Retirement Board</u> 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 court placed emphasis on the IRS's requirements necessary to establish a valid "pick-up" plan under section 414(h)(2). The taxpayer had argued 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 taxpayer'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 <u>Public Employees' Retirement Board</u>. 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.

We note the court found "the term 'salary reduction agreement' is not ambiguous but rather has a plain meaning." 153 F.3d at 1163 (Emphasis added.). This discussion by the court strongly militates against giving language in section 3121(a)(5)(D) a different interpretation than the similar language in section 3121(v)(1)(B) when there is no provision within section 3121 indicating the language should be interpreted differently or no surrounding language supporting a different interpretation. Absent a specific statutory directive within the FICA, the language "salary reduction agreement (whether evidenced by a written instrument or otherwise)" should be given a similar interpretation within the same section of the Internal Revenue Code. 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 <u>Public Employees</u>. Of particular significance is the fact 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 taxpayer does not believe that <u>Public Employees'</u> has any relevance to its ruling request because the claim is made that the court's interpretation of the term "salary reduction agreement" in section 3121(v)(1)(B) in the case was dictated by the Service's definition of what constitutes a valid pick-up under section 414(h)(2). The taxpayer contrasts the mandatory status of pick-up contributions under section 414(h)(2) with contributions from employees' salaries under section 403(b) plans which "may be either voluntary or mandatory." Thus, their position that salary reduction agreement for purposes of section 403(b) includes only "voluntary" agreements would mean that certain contributions to section 403(b) plans would still continue to be subject to FICA taxes as contributions under a salary reduction agreement.

We do not believe Congress intended for the same language within the same Code section to have such a contradictory interpretation. The <u>Public Employees</u> 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 any 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.

Broad interpretation of "wages" supported by the courts

The courts have generally recognized that the term "wages" in section 3121(a) is to be interpreted broadly. The corollary of that rule is that exceptions from wages are to be interpreted narrowly. In State of New Mexico v. Weinberger, 517 F.2d 989, 993 (10th Cir. 1975), the Court of Appeals for the Tenth Circuit recognized "the Congressional policy underlying Federal Social Security legislation which requires courts to interpret the Act liberally, and to resolve any doubts in favor of coverage." Consideration of the purposes of FICA taxation supports applying the Tenth Circuit's interpretation of "salary reduction agreement" in Public Employees' Retirement Board for purposes of section 3121(a)(5)(D). Also, the recent cases emphasizing the expansive nature of the definition of wages for purposes of the FICA appear to suggest a more restrictive definition of "salary reduction agreement" for purposes of section 3121(a)(5)(D) would not be justified.

Under section 3121(a), "wages" is defined as remuneration for employment. The broad interpretation of the terms "wages" and "employment" arises from the purpose of the legislation providing social security benefits and taxes to finance those benefits: "The purpose of the ... Social Security Act is to provide funds through contributions by employer and employee for the decent support of elderly workmen who have ceased to

labor." <u>Social Security Board v. Nierotko</u>, 327 U.S. 358, 364 (1946), (citing <u>Helvering v. Davis</u>, 301 U.S. 619, 641 (1937)). In <u>Associated Electric Cooperative</u>, Inc. v. United <u>States</u>, 226 F.3d 1322, 1326 (Fed Cir. 2000), the court stated as follows: "In enacting the FICA tax provisions, Congress intended to impose FICA taxes on a broad range of employer-furnished remuneration in order to accomplish the remedial purpose of the Social Security Act."

Other cases which held that "wages" and "employment" are given a broad interpretation include Mayberry v. United States, 151 F.3d 855, 860 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204, 209 (4th Cir. 1997); and Lane Processing Trust v. United States, 25 F.3d 662, 665 (8th Cir. 1994). But see, Dotson v. United States, 87 F.3d 682 (5th Cir. 1996), in which the court held that a settlement of an action under the Employee Retirement Income Security Act (ERISA) was excludable from FICA wages except to the extent the settlement included back pay.

Thus, there is an additional fundamental reason why the term "salary reduction agreement" should be given a broad interpretation for purposes of section 3121 that is not present in determining whether the nondiscrimination requirements applicable to section 403(b) plans are met or whether the contribution is an elective deferral.

SUMMARY

In light of the above, we have concluded the contributions at issue here are being made pursuant to salary reduction agreements and therefore 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

Plan A is generally available to faculty members and certain other personnel in all State C educational establishments in State C and certain other State C entities. Thus, refund claims from educational establishments that are part of the State C university system related to Plan A contributions should be denied. Also, refund claims from other related State C entities related to Plan A contributions should also be denied.

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