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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[TD 9367]

RIN 1545-BH00

Payments Made by Reason of a Salary Reduction Agreement

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document promulgates a final regulation that defines the term salary reduction agreement for purposes of section 3121(a)(5)(D) of the Internal Revenue Code (Code). The final regulation provides guidance to employers (public educational institutions and section 501(c)(3) organizations) purchasing annuity contracts described in section 403(b) on behalf of their employees.

DATES: Effective Date: This regulation is effective November 15, 2007.

Applicability Date: This regulation applies to contributions to section 403(b) plans made on or after November 15, 2007.

FOR FURTHER INFORMATION CONTACT: Neil D. Shepherd, (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This final regulation amends the Employment Tax Regulations (26 CFR part 31) by providing guidance relating to section 3121(a)(5)(D). The Federal

Insurance Contributions Act (FICA) imposes taxes on employees and employers equal to a percentage of the wages received with respect to employment.

Section 3121(a) defines wages for FICA tax purposes as all remuneration for employment unless otherwise excepted. Section 3121(a)(5)(D), added by the Social Security Amendments of 1983 (Public Law 98-21 (97 Stat. 65)), generally excepts from wages payments made by an employer for the purchase of an annuity contract described in section 403(b). However section 3121(a)(5)(D) expressly excludes from the exception payments made by reason of a salary reduction agreement (whether evidenced by a written instrument or otherwise). Thus, payments made under a salary reduction agreement to purchase a section 403(b) annuity contract are included in wages for FICA purposes. A temporary and proposed regulation defining the term "salary reduction agreement" for purposes of section 3121(a)(5)(D) was published in the **Federal Register** (69 FR 67054) on November 16, 2004.

For income tax purposes, contributions made by an employer to a section 403(b) contract, including contributions made pursuant to a cash or deferred election or other salary reduction agreement, are generally excluded from income. §403(b); see also section 1450(a) of the Small Business Job Protection Act of 1996 (Public Law 104-188 (110 Stat. 1755)). Conversely, for FICA tax purposes, contributions made by an employer to a section 403(b) contract pursuant to a cash or deferred election or other salary reduction agreement are included in wages. §3121(a)(5)(D); see also S. Rep. No. 98-23, at 40-41, 98th Cong., 1st Sess. (1983).

Summary of Comments and Explanation of Provisions

This regulation finalizes the temporary and proposed regulation without change. The final regulation provides that the term “salary reduction agreement” includes (1) a plan or arrangement whereby a payment will be made if the employee elects to reduce his or her compensation pursuant to a cash or deferred election as defined at §1.401(k)-1(a)(3) of the Income Tax Regulations, (2) a plan or arrangement whereby a payment will be made if the employee elects to reduce his or her compensation pursuant to a one-time irrevocable election made at or before the time of initial eligibility to participate in such plan or arrangement (or pursuant to a similar arrangement involving a one-time irrevocable election), and (3) a plan or arrangement whereby a payment will be made if the employee agrees as a condition of employment (whether such condition is set by statute, contract, or otherwise) to make a contribution that reduces the employee's compensation.

Comments were submitted with respect to the definition of the term “salary reduction agreement” for purposes of section 3121(a)(5)(D) and with respect to the applicability date of the temporary and proposed regulation.

Salary Reduction Agreement

Commentators asserted that Congress intended the term “salary reduction agreement” in section 3121(a)(5)(D) to apply only to voluntary reductions in salary and not to salary reductions required as a condition of employment. In support of this view, commentators cited the legislative history underlying section 3121(a)(5)(D), particularly the following language from the Senate

Report:

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 Cum. Bull. 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."

S. Rep. No. 98-23, at 40-41, 98th Cong., 1st Sess. (1983).

Commentators maintained that Revenue Ruling 65-208 distinguishes between voluntary and mandatory salary reduction contributions and that the legislative history reflects Congress' intent to treat only voluntary salary reduction contributions as having been made by reason of a salary reduction agreement. While the Senate Report indicates a Congressional intent to "codify the holding of Revenue Ruling 65-208," the revenue ruling does not address any distinction between voluntary and mandatory reductions in salary. The critical distinction drawn in Revenue Ruling 65-208 is between situations "where an organization uses its own funds for the purchase of an annuity contract" (a supplemental contribution) and situations "where the employee takes a voluntary reduction in salary to provide the necessary funds" (a salary reduction contribution). At the time Revenue Ruling 65-208 was issued the statutory standard under section 3121(a)(2) for determining whether to include contributions to section 403(b) annuity contracts in wages for FICA purposes was whether the contributions had been paid by the employer or by the employee. Thus, in determining whether the employer or the employee has paid the contribution, the revenue ruling distinguishes between supplemental contributions funded by the

employer and salary reduction contributions funded by the employee. Whether a salary reduction contribution was voluntary or mandatory is irrelevant in establishing that the employee funded the contribution through a reduction in salary.

Several courts have discussed Revenue Ruling 65-208 and confirmed that it addresses the distinction between salary supplements and salary reductions. See Temple University v. United States, 769 F.2d 126, 130 (3d Cir. 1985), discussing the distinction drawn by Revenue Ruling 65-208 between supplemental contributions and salary reduction contributions, and Canisius College v. United States, 799 F.2d 18, 20-21 (2d Cir. 1986), distinguishing between “salary supplement plans” and “salary reduction plans.” See also University of Chicago v. United States, No. 06 C 3452, 2007 U.S. Dist. LEXIS 61632, at *8 (N.D. Ill. Aug. 21, 2007) concluding that “the distinction that was being drawn in [Revenue Ruling 65-208] was between annuity purchase funds that come from employee contributions and those that come from employer contributions.” The Treasury Department and the Internal Revenue Service (IRS) continue to believe that it is consistent with the legislative history of section 3121(a)(5)(D) and with the codification of Revenue Ruling 65-208 to treat both voluntary salary reductions and salary reductions to which the employee agrees as a condition of employment as payments made pursuant to a salary reduction agreement.

Commentators suggested that the term “salary reduction agreement” for purposes of section 3121(a)(5)(D) should mean an elective deferral within the

meaning of section 402(g)(3)(C), which defines the term elective deferral for purposes of the section 402(g)(3) limit on the exclusion of elective deferrals from gross income. In their view, because salary reduction contributions made pursuant to a one-time irrevocable election or as a condition of employment are not elective deferrals under section 402(g)(3)(C) and its accompanying regulations, such contributions are not made pursuant to a salary reduction agreement and, consequently, are excluded from wages under section 3121(a)(5)(D).

Section 402(g)(3)(C) provides that the term “elective deferral” includes “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)).” However, when enacting section 402(g)(3), Congress made the following statement about the relationship among mandatory salary reduction contributions, elective deferrals, and salary reduction agreements: “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.” H.R. Rep. No. 99-841 at II-405 (1986). Similarly, in 1988 Congress added the flush language of 402(g)(3) providing that a one-time irrevocable election will not be treated as an elective deferral. Congress added the flush language to clarify that the term “elective deferral” excludes contributions “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).”

S. Rep. No. 100-445, at 151, 100th Cong., 2d Sess. (1988). Congress explained the clarification to section 402(g)(3) as follows:

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).

Sen. Rep. 100-445, 100th Cong., 2d Sess. (1988) 151.

Thus, as reflected in both the statutory language of section 402(g) and in its legislative history, Congress intended the definition of salary reduction agreement for purposes of section 3121(a)(5)(D) to be distinct from the definition of elective deferral for purposes of section 402(g)(3)(C).

Furthermore, Congress intended that the term wages would have different meanings for income tax withholding and FICA tax purposes. The broader scope of the term for FICA tax purposes is consistent with the general policy underlying the FICA. See S. Rep. No. 98-23, at 39, 98th Cong., 1st Sess. (1983) relating to the Social Security Amendments of 1983 (Public Law 98-21 (97 Stat. 65)).

Moreover, the legislative history to section 3121(a)(5)(D) cited in this preamble describes Congress's intent to codify the holding in Revenue Ruling 65-208 (see §601.601(d)(2)(ii)(b)), which provides that certain amounts included in income and amounts included in wages with respect to contributions used to purchase a 403(b) annuity contract are not the same. Based on the statutory language and the legislative history of section 3121(a)(5)(D) and related provisions, including section 3121(v)(1)(B) as discussed in this preamble, the Treasury Department

and the IRS continue to believe that the term “salary reduction agreement” in section 3121(a)(5)(D) includes salary reduction contributions made pursuant to a one-time irrevocable election or as a condition of employment.

The term “salary reduction agreement” is used not only in section 3121(a)(5)(D) but also in another subsection of section 3121, specifically section 3121(v)(1)(B), which provides that wages include “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).” Commentators contended that the term “salary reduction agreement” should be interpreted differently for purposes of sections 3121(a)(5)(D) and 3121(v)(1)(B) because section 3121(v)(1)(B) applies only to salary reduction contributions made under a section 414(h) pick-up plan established by a State or local government employer. By definition, the salary reductions that fund these employer contributions are mandatory whereas contributions to section 403(b) annuity plans may be mandatory or voluntary. While it is correct that salary reductions in connection with section 414(h) pick-up plans are mandatory, we see no evidence in the statute or legislative history that Congress intended to interpret the same language differently or to treat similarly situated employees differently for FICA purposes. Both section 3121(a)(5)(D) and section 3121(v)(1)(B) include salary reduction contributions in wages for FICA tax purposes. Neither the statute nor the legislative history gives a basis for concluding that mandatory salary reductions made in connection with a section 414(h) pick-up plan should be included in wages for FICA purposes while

mandatory salary reductions made in connection with a section 403(b) annuity plan should be excluded from wages. Thus, the Treasury Department and the IRS continue to believe that it is appropriate to give a consistent interpretation to identical language in two subsections of the same statutory section enacted only one year apart.

Similarly, as discussed in the preamble to the temporary and proposed regulation, the Tenth Circuit's decision in Public Employees' Retirement Board v. Shalala, 153 F.3d 1160 (10th Cir. 1998) supports the view that a mandatory salary reduction contribution nonetheless requires the employee's agreement. In Public Employees' Retirement Board the Court of Appeals held that the term "salary reduction agreement" includes mandatory salary reduction contributions made as a condition of employment. As the Court said, "[A]n employee's decision to go to work or continue to work . . . constitutes conduct manifesting assent to a salary reduction." 153 F.3d at 1166. The employment relationship itself is a voluntary relationship, and the employee manifests his or her agreement with the terms and conditions of the employment relationship by accepting employment. See University of Chicago v. United States, No. 06 C 3452, 2007 U.S. Dist. LEXIS 61632, at *7 (N.D. Ill. Aug. 21, 2007) citing Public Employees' Retirement Board for the proposition that "a salary reduction agreed to as a condition of employment constitutes a salary reduction agreement because 'the employee has "agreed" to the salary reduction by continuing employment.'" The temporary and proposed regulations, and now the final regulations, read the term "agreement" for purposes of section 3121(a)(5)(D) as

the Tenth Circuit read it for purposes of section 3121(v)(1)(B), as both an agreement to accept employment subject to a mandatory salary reduction and an agreement to a specified salary reduction.

Accordingly, the final regulation adopts the definition of salary reduction agreement as proposed.

Applicability Date

Commentators asked the IRS to confirm that the definition of salary reduction agreement provided in the temporary and proposed regulation would apply prospectively only and, therefore, would not affect contributions to a section 403(b) plan made prior to November 16, 2004, the date the temporary and proposed regulation went into effect. As explicitly set forth in §31.3121(a)(5)-2T the temporary and proposed regulation was applicable to contributions to section 403(b) annuity plans made on or after November 16, 2004. Therefore, the Internal Revenue Service will not apply the temporary and proposed regulation to contributions made to any section 403(b) plan prior to November 16, 2004, for purposes of determining whether such contributions were subject to FICA tax. The final regulation will apply only to contributions made to any section 403(b) plan on or after November 15, 2007.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) do not apply to this

regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Drafting Information

The principal author of this regulation is Neil D. Shepherd, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in its development.

List of Subjects in 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 is amended as follows:

PART 31--EMPLOYMENT TAXES

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 31.3121(a)(5)-2 is added to read as follows:

§31.3121(a)(5)-2 Payments under or to an annuity contract described in section 403(b).

(a) Salary reduction agreement defined. For purposes of section 3121(a)(5)(D), the term salary reduction agreement means a plan or

arrangement (whether evidenced by a written instrument or otherwise) whereby payment will be made by an employer, on behalf of an employee or his or her beneficiary, under or to an annuity contract described in section 403(b)--

(1) If the employee elects to reduce his or her compensation pursuant to a cash or deferred election as defined at §1.401(k)-1(a)(3) of this chapter;

(2) If the employee elects to reduce his or her compensation pursuant to a one-time irrevocable election made at or before the time of initial eligibility to participate in such plan or arrangement (or pursuant to a similar arrangement involving a one-time irrevocable election); or

(3) If the employee agrees as a condition of employment (whether such condition is set by statute, contract, or otherwise) to make a contribution that reduces his or her compensation.

(b) Effective/applicability date. This section is applicable on November 15, 2007.

§31.3121(a)(5)-2T [Removed]

Par. 3. Section 31.3121(a)(5)-2T is removed.

Deputy Commissioner for Services and Enforcement.

Linda E. Stiff

Approved: November 13, 2007

Assistant Secretary of the Treasury (Tax Policy).

Eric Solomon