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CHIEF COUNSEL

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The Honorable Zach Wamp
Member, U.S. House of Representatives
Federal Building, Suite 100
200 Administration Road
Oak Ridge, Tennessee 37402

Attention:

Dear Congressman Wamp:

This letter is in response to your inquiry dated , on behalf of your constituents, the employees of concerning the taxation of employer contributions to section 401(k) plans and section 457(b) deferred compensation arrangements. The employees are specifically concerned that "unlike 401(k)'s and other retirement plans, our 457(b) plan must withhold social security and Medicare taxes on the employer's contribution." As explained below, the law provides that contributions to certain types of deferred compensation arrangements, such as 401(k) and 457(b) plans, are subject to social security and Medicare taxes, whereas contributions to other types of deferred compensation arrangements are not.

Taxes under the Federal Insurance Contributions Act (FICA) consist of the old-age, survivors, and disability portion (social security) and the hospital insurance portion (Medicare) and are computed as a percentage of wages paid by the employer and received by the employee for employment. [Internal Revenue Code (Code) sections 3101, 3111, and 3121]. Generally all remuneration an employer pays for services an employee performs is subject to FICA taxes unless the law specifically excepts the remuneration from the term "wages" or excepts the services from the term "employment." [Code sections 3101, 3111, and 3121].

A deferred compensation arrangement is any plan, program, or agreement under which an employer promises to pay an amount to an employee at some future date for his past, present, or in some cases, future services. A deferred compensation arrangement can be either "qualified" or "nonqualified." Generally, a plan must contain specific

statutorily-mandated provisions to be treated as a "qualified plan" under Code section 401(a), including requirements for funding, nondiscrimination, employee coverage, and distributions.

Deferred compensation arrangements have the basic advantage of deferring income tax on amounts the employer contributes to the plan until they are distributed to the employee. However, contributions to deferred compensation arrangements may or may not be subject to FICA taxes at the time the employer makes the contributions, depending on the type of arrangement.

The law specifically excludes from wages for FICA tax purposes employer contributions made on behalf of an employee to a tax qualified plan that satisfies all the requirements of Code section 401(a). [Code section 3121(a)(5)(A)]. In contrast, the law provides that employer contributions made under a section 401(k) qualified cash or deferred arrangement are included in wages and subject to FICA tax. [Code section 3121(v)(1)(A)]. A qualified cash or deferred arrangement is one that allows an employee to elect to have the employer's contribution made to the plan on the employee's behalf or directly to the employee in the form of cash or some other taxable benefit.

Code section 457 provides rules for nonqualified deferred compensation plans established by eligible employers. State and local governments and tax-exempt organizations are eligible employers. An eligible State deferred compensation plan is one that meets the requirements of Code section 457(b). Generally, amounts deferred under a section 457(b) plan are included in wages and subject to FICA taxes at the time of deferral. [Code section 3121(v)(2)(A)].

Thus, the FICA tax treatment of employee designated contributions to section 401(k) and 457(b) plans is identical. In both cases such contributions are subject to FICA taxation when made by the employer on behalf of the employee.

The employees' letter asserts that the FICA taxation of amounts deferred under a Code section 457(b) plan discourages savings, and that this taxation discriminates against employees covered by a 457(b) plan, when contributions to other plans are exempt from FICA taxation.

Congress did not intend to discourage participants in 457(b) plans and similar arrangements from saving for retirement. Rather, Congress enacted section 3121(v) to protect the social security wage base. [See the Social Security Act Amendments of 1983, Public Law 98-21. The Senate Committee on Finance provided insight into the reasons Congress enacted section 3121(v):

> Generally, if an employee receives cash and then chooses to use these funds for personal savings or benefits, the amount of cash received is subject to FICA. This is true, for example, for contributions to an individual retirement account (IRA) even if the employer transmits the funds directly to the IRA account.
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> 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, March 11, 1983].

Any change to the law would require legislative action.

I hope this information is helpful. Please contact me at or if you need further assistance.

Sincerely,

Catherine E. Livingston
Assistant Chief Counsel (Exempt Organizations/ Employment Tax/Government Entities)
Tax Exempt & Government Entities