

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[TD 9159]

RIN 1545-BD50

Payments Made by Reason of a Salary Reduction Agreement

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulation.

SUMMARY: This document contains a temporary regulation that defines the term “salary reduction agreement” for purposes of section 3121(a)(5)(D) of the Internal Revenue Code (Code). The temporary 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. The text of the temporary regulation also serves as the text of the proposed regulation set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: This regulation is effective on November 16, 2004.

Applicability Date: For dates of applicability, see §31.3121(a)(5)-2T(b).

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

SUPPLEMENTARY INFORMATION:

**Background**

This temporary regulation (REG-155608-02) 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. Code section 3121(a) defines wages for FICA tax purposes as all remuneration for employment unless otherwise excepted. Code 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). In a codification of long-standing administrative practice, 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.) See Rev. Rul. 65-208, 1965-2 C.B. 383, and S. Rep. No. 98-23, at 41, 98<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1983). This temporary regulation defines the term “salary reduction agreement” for purposes of section 3121(a)(5)(D).

### **Explanation of Provisions**

The FICA taxation of payments made by an employer for the purchase of annuity contracts described in section 403(b) has been shaped by a congressional concern for the social security revenue base and for employees’ social security benefits. In the context of contributions for the purchase of such annuity contracts, Congress has interpreted the term “wages” for FICA tax purposes more broadly than the term “gross income” for income tax purposes. See S. Rep. No. 98-23, at 39, 98<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1983) relating to the Social Security Amendments of 1983 (Public Law 98-21 (97 Stat. 65)).

An amount is generally includible in wages for FICA tax purposes at the time it is

actually or constructively paid by the employer and received by the employee.

Additionally, wages generally include an amount that an employer contributes to a plan only if the employee agrees to reduce his or her compensation. For income tax purposes, however, section 403(b) provides an exclusion from gross income for contributions made by an employer, including contributions made pursuant to a cash or deferred election or other salary reduction agreement. See section 1450(a) of the Small Business Job Protection Act of 1996 (Public Law 104-188 (110 Stat. 1755)). Conversely, for FICA tax purposes, wages include contributions made by an employer to a section 403(b) contract pursuant to a cash or deferred election or other salary reduction agreement. See S. Rep. No. 98-23, at 40-41, 98<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1983). Thus, while section 403(b) excludes from gross income contributions made pursuant to certain cash or deferred elections, such contributions are made by reason of a salary reduction agreement under section 3121(a)(5)(D) and are included in wages for FICA tax purposes. Consequently, this temporary regulation explicitly provides that the term “salary reduction agreement” includes 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.

Pursuant to regulation §1.401(k)-1(a)(3)(iv) of this chapter, a cash or deferred election does not include a one-time irrevocable election made upon an employee’s commencement of employment with the employer. Similarly, pursuant to section 402(g)(3), while the term “elective deferrals” generally 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)), an employer

contribution made pursuant to a one-time irrevocable election is not treated as an elective deferral. See H.R. Rep. No. 100-795, at 145, 100<sup>th</sup> Cong., 2<sup>d</sup> Sess. (1988) and S. Rep. No. 100-445, at 151, 100<sup>th</sup> Cong., 2<sup>d</sup> Sess. (1988) relating to the amendment of section 402(g)(3) by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100-647 (102 Stat. 3342)). Notwithstanding that section 403(b) contributions made pursuant to a one-time irrevocable election are excluded from cash or deferred elections under section 401(k) and from elective deferrals under section 402(g)(3), such contributions are made pursuant to a salary reduction agreement. If the employee had not made a one-time irrevocable election, the employer's cash payment to the employee would be includible in the employee's gross income and in wages for FICA tax purposes. Consequently, this temporary regulation explicitly provides that the term "salary reduction agreement" includes 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).

A contribution that is made as a condition of employment and that reduces an employee's compensation generally constitutes an employee contribution includible in wages for FICA tax purposes. See section 1015 of the Employee Retirement Income Security Act of 1974 (Public Law 93-406 (88 Stat. 829)) relating to amounts designated as employee contributions under section 414(h) of the Code; see also H.R. Rep. No. 93-807, at 145, 93<sup>d</sup> Cong., 2<sup>d</sup> Sess. (1974) wherein Congress stated that "[u]nder present law, contributions which are designated as employee contributions are generally

treated as employee contributions for purposes of the Federal tax law.” Code section 414(h)(1) merely codified the existing administrative and judicial treatment of amounts designated as employee contributions. See, for example, Howell v. United States, 775 F.2d 887 (7<sup>th</sup> Cir. 1985) holding that mandatory contributions to a state retirement plan of amounts designated as employee contributions and withheld from the employee's salary are employee contributions includible in the employee's gross income. Thus, as with employer contributions made pursuant to cash or deferred elections and one-time irrevocable elections, employer contributions that are made as a condition of employment and in lieu of mandatory employee contributions and that reduce an employee's compensation are amounts otherwise includible in wages for FICA tax purposes.

Whether a contribution that reduces an employee's compensation is required by statute, contract, or otherwise, an employee implicitly agrees to the contribution as a condition of employment. The acceptance of employment and the subsequent performance of services manifests the employee's agreement to the contribution. See H.R. Conf. Rep. No. 98-861, at 1415, 98<sup>th</sup> Cong., 2<sup>d</sup> Sess. (1984) relating to the amendment of section 3121(v)(1)(B), wherein Congress stated that “[t]he 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.” In Public Employees' Retirement Board v. Shalala, 153 F.3<sup>rd</sup> 1160, at 1166 (10<sup>th</sup> Cir. 1998), the court noted that “an employee's decision to go to work or continue to work . . . constitutes conduct manifesting assent to a salary reduction.” Accordingly, the

court held that a designated employee contribution picked up by an employer with a corresponding reduction in the employee's gross salary constitutes a contribution made pursuant to a salary reduction agreement. Similarly, this temporary regulation explicitly provides that the term "salary reduction agreement" includes 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.

### **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. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section in the preamble to the notice of proposed rule making published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, this temporary regulation will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

### **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.

### **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)-2T is added to read as follows:

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

(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 date. (1) This section is applicable on November 16, 2004.

(2) The applicability of this section expires on or before November 16, 2007.

/s/ Nancy Jardini  
Acting Deputy Commissioner for Services and Enforcement.

Approved: November 1, 2004

/s/ Gregory Jenner  
Acting Assistant Secretary of the Treasury.