



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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The Honorable Mel Martinez
United States Senator
315 East Robinson Street, Suite 475
Orlando, Florida 32801

Attention:

Dear Senator Martinez:

This letter is in response to your inquiry dated October 23, 2006, on behalf of your constituent, . asked whether the can legally stop withholding and paying taxes under the Federal Insurance Contributions Act (FICA) on wages it pays to certain employees and how this decision will effect employees' retirement benefits.

We cannot provide an opinion about the legality of the university's decision to discontinue its social security contributions or address how this decision may affect employees' retirement benefits. However, we can provide you with general information about when the wages state and local governments or their instrumentalities pay to employees are not subject to FICA taxes.

FICA taxes consist of Old-Age, Survivors, and Disability Insurance taxes, also known as social security taxes, and hospital insurance taxes, also known as Medicare taxes. Employees and employers must pay FICA taxes under sections 3101 and 3111 of the Internal Revenue Code (the Code). Generally, all wages an employer pays for services an employee performs are subject to FICA taxes unless the law specifically exempts the payments from the term "wages" or the services from the term "employment." The Code defines those terms in sections 3121(a) and (b).

The law generally excludes from "employment" services individuals perform in the employ of any state, political subdivision, or their instrumentalities (such as a state university, for example). However, the exception from employment does not apply to services included under a "section 218 agreement" (section 3121(b)(7)(E) of the Code).

A section 218 agreement is a voluntary agreement between a state and the Social Security Administration (SSA) to provide social security coverage for employees of state or local governments and their instrumentalities.

Since 1991, if the services state or local government employees perform are not included under a section 218 agreement, the exception from employment will not apply to them unless they are members of the retirement system of a state, political subdivision, or their instrumentalities (section 3121(b)(7)(F) of the Code). Thus, state and local government employers must withhold and pay FICA taxes, subject to limited exceptions, if their employees do not participate in a public retirement system (section 3121(b)(7)(F) of the Code). These employers are exempt from the social security portion of FICA taxes, if the employees are not covered by a section 218 agreement but are members of a public retirement system.

Whether a retirement arrangement is a retirement system within the meaning of section 3121(b)(7)(F) of the Code generally depends on whether the retirement arrangement provides benefits equivalent to social security benefits. If a taxpayer wants a ruling that its retirement arrangement is a retirement system for FICA purposes, the taxpayer may request a private letter ruling. Revenue Procedure 2006-1, 2006-1 I.R.B. 1, provides instructions for submitting a request for a private letter ruling. I am enclosing a copy for your information.

Employees of state and local governments and their instrumentalities who are members of a public retirement system and, therefore, exempt from the social security portion of FICA under section 3121(b)(7)(F) of the Code, may still be subject to the Medicare portion of the FICA taxes. All employees hired by state or local governments after March 31, 1986, are subject to the Medicare portion of FICA regardless of membership in an employer's retirement system (section 3121(u)(2)(A) of the Code) However, under section 3121(u)(2)(C) of the Code, employees hired before April 1, 1986, are exempt from Medicare (unless covered by a section 218 agreement) if:

- The employees are members of a public retirement system
- The employees were bona fide employees of the employer on March 31, 1986
- The employees performed regular and substantial services for remuneration for the employer before April 1, 1986
- The employee has worked continuously since March 31, 1986
- The employee and employer did not enter into the employment relationship to avoid paying the Medicare tax

Services that students perform as employees of schools, colleges, or universities at which they are enrolled and regularly attend classes are excepted from the definition of "employment" for FICA tax purposes (section 3121(b)(10) of the Code). Thus, wages employers pay to such students are exempt from both the social security and Medicare portions of FICA taxes.

Although this letter is not a ruling, I hope the information is helpful. If you have further questions, please contact me or _____ at () _____ .

Sincerely,

Lynne Camillo
Chief, Employment Tax Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure