Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:TEGE:EOEG:ET2 / PLR-121014-01
Date:
May 24, 2002

In Re:

Legend

State:
Taxpayer:
Plan:
X:
Y:

Dear

This relates to your letter dated April 10, 2001, requesting a private letter ruling that compulsory contributions made pursuant to a nonqualified defined contribution plan (the Plan) and used to purchase retirement annuity contracts described in section 403(b) are excludible from the term "wages" for purposes of the Federal Insurance Contributions Act (FICA). For the reasons set forth below, we conclude that they are not.

Facts

Taxpayer is a board composed of members appointed by the governor and confirmed by the senate of State. Taxpayer controls, operates, and manages certain state educational institutions. Taxpayer appoints the chief executive officers of the educational institutions, who serve at Taxpayer's pleasure and receive such compensation as Taxpayer prescribes. The chief executive officer of each educational institution (designated as either the chancellor or president) appoints such employees as are authorized by Taxpayer.

The civil service of State is divided into the unclassified and the classified services. The unclassified service includes certain positions held by state officers or employees, including the chancellor, president, deans, administrative officers, student health service physicians, pharmacists, teaching and research personnel, health care employees, and student employees of the educational institutions under Taxpayer's control. Unclassified employees of the educational institutions receive such compensation as is prescribed by the chief executive officer, subject to policies approved by Taxpayer. Employees of the educational institutions who are not in the unclassified service are in the classified service of the State civil service act.

Salaries and wages for unclassified employees are required by State statute to be fixed on an annual basis prior to the beginning of each fiscal year. Accordingly, Taxpayer enters into a contract of appointment with each unclassified employee on an annual basis. The contract of appointment specifically identifies the position offered, the term of appointment (generally either nine or twelve months), and the base salary paid to each unclassified employee.

Pursuant to State statute Taxpayer is required to assist all persons who are employed by Taxpayer or by educational institutions under its management and who are in the unclassified service under the State civil service act in the purchase of retirement annuities. Specifically, all unclassified employees employed half-time or more must begin participating in and contributing to the Plan on the first day of the pay period coinciding with or next following the completion of one year of service. Failure of an eligible employee to participate is cause for immediate termination. Contributions under the Plan are applied to the development of individual employee account balances and to the purchase of annuity contracts from one of four life insurance companies authorized by Taxpayer to participate in the Plan.

State statute requires all eligible employees to contribute an amount toward the purchase of retirement annuities equal to X% of their salaries, "such contributions to be made through payroll deductions and on a pretax basis."[1] The employee's base salary as set forth in the appointment contract is reduced by X% to fund the employee's retirement plan contribution. State statute also requires that Taxpayer contribute an amount toward the purchase of such retirement annuities equal to Y% of the employees' base salaries. Thus, as a participant in the Plan, the employee contributes a percentage of his base salary and Taxpayer contributes an amount equal to a percentage of the employee's base salary. These amounts are remitted to the employee's selected investment provider each pay period.

All contributions vest immediately and the current value of the contributions is payable to beneficiaries if the employee dies before retirement. Thus, the employee's retirement account is 100% vested and nonforfeitable. However, distributions from the Plan may only be made upon retirement, separation from service, disability, death, or the demonstration of financial hardship. In the event a participant in the Plan terminates employment for reasons other than retirement or disability and requests the

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[1] Benefits eligible employees may begin making voluntary tax-deferred contributions immediately upon employment. These voluntary contributions may also be used to supplement the mandatory retirement plan.

distribution of his or her accounts, the employing institution must first certify that the employee has terminated employment.

State statute provides that the employees' required contributions are to be made "on a pretax basis." The Plan does not, however, specifically require that eligible employees execute a salary reduction agreement. Taxpayer's retirement resolution (describing the provisions of the Plan as authorized by law and established by Taxpayer) provides that Plan contributions by a participant will be made on a tax-deferred basis under an agreement for salary reduction executed in accordance with section 403(b). In relevant part, the prescribed salary reduction agreement authorizes and directs Taxpayer to reduce the eligible employee's compensation to purchase a non-forfeitable annuity. Specifically, Taxpayer is authorized to reduce the employee's base compensation under the required matching retirement plan by X% applicable each pay period and to pay an additional amount of Y% to provide retirement benefits as described under the applicable statute. Finally, Taxpayer is directed to apply said sums to the payment of deposits for a retirement annuity contract selected by the employee in accordance with the terms of the required matching retirement program.

The salary reduction agreement provides that it is legally binding and irrevocable while employment continues and that it will remain in force for the duration of employment. The salary reduction agreement is signed and dated by the employee and by the Division of Human Resources on behalf of Taxpayer. Until an eligible employee signs a salary reduction agreement form and is enrolled in a basic retirement plan, the employee's X% contribution is held in a non-interest bearing clearing fund. Neither the employee's nor the Taxpayer's contributions are credited with interest while in this clearing fund nor is interest credited retroactively.

Legal Analysis

Taxpayer requests a ruling that compulsory contributions made pursuant to the Plan and used to purchase retirement annuity contracts described in section 403(b) are excludible from wages for FICA tax purposes. Code sections 3101 and 3111 impose FICA taxes on employees and employers, respectively, equal to a percentage of the wages received by an individual with respect to employment. Code section 3121(a) defines wages for FICA tax purposes as all remuneration for employment unless specifically excepted. Code section 3121(a)(5)(D) provides that wages do not include 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. Employee contributions (i.e., after-tax contributions) made through salary deductions and used to purchase annuity contracts are includible in wages for FICA tax purposes.

Code section 403(b)(1) provides that amounts contributed by certain employers for the purchase of an annuity contract for an employee are excludible from the gross income of the employee if certain requirements are satisfied. While annuity contracts described in section 403(b) are generally purchased with amounts contributed by an employer, the employer's contributions are not required to be "merely a supplement to past or current compensation." Treas. Reg. §1.403(b)-1(b)(3). Thus, the exclusion is applicable to amounts contributed by an employer for an annuity contract as a result of an agreement with an employee to take a reduction in salary. As with wages for FICA tax purposes, employee contributions made through salary deductions and used to purchase annuity contracts are includible in the employee's gross income.

To determine whether compulsory contributions made pursuant to the Plan and used to purchase retirement annuity contracts are excludible from wages for FICA tax purposes, we must first determine whether such compulsory contributions constitute employer contributions for purposes of section 403(b) and section 3121(a)(5)(D). In Revenue Ruling 56-473, 1956-2 C.B. 22, the Service considered the treatment for Federal income tax purposes of amounts deducted from the salaries of public employees of the State of Arizona and credited to their retirement accounts pursuant to the state's retirement system. The pertinent provisions of the retirement system act provided for open-end annuities, conditional upon retirement, and a pension based on prior service. The benefits were not measured by salaries or length of service but, rather, were dependent entirely upon the amount credited to the individual upon retirement. The account was made up of public funds equal to seven percent of the gross authorized salary for all public employment while a member of the retirement system. The seven percent credit was specified as a three and one-half percent contribution of the authorized salary by the member and the contribution of an equal percent by the state.

Under the act, the phrase "authorized salary" was used to emphasize the distinction between the gross pay and the amount remaining to the employee after crediting and deducting the three and one-half percent contribution. The contributions by the members were held by a retirement board and became available to the employee only when the employee terminated his employment with the state and withdrew his contributions. When the employee applied for retirement benefits at or after age 60, he received an annuity consisting of his own contributions, the employer contributions, and earnings on all of the funds in his account.

The Service concluded that, with respect to the inclusion in income, compulsory contributions designated as employee contributions should be treated as employee contributions for purposes of the employee's annuities. When an individual accepted employment with the State of Arizona, he was subject to all the conditions and provisions of law relating to the Arizona retirement system. As such, he impliedly consented to the withholding of a part of his compensation for the purpose of purchasing an annuity which, under the retirement system, became a vested right upon his retirement. Accordingly, the Service held that the amounts deducted from the compensation of employees of the State of Arizona and credited to their retirement accounts constituted gross income within the meaning of section 61(a) and should be reported in the employees' annual Federal income tax returns for the year in which deducted.

In Revenue Ruling 57-326, 1957-2 C.B. 42, the Service considered whether compulsory but nonforfeitable contributions to a state retirement plan were includible in an employee's gross income. The Service held that where under an ordinance or statute of a municipality or state there is an employees' retirement plan, wherein employee participation is compulsory, which contains a provision for the refund of an employee's contributions in the event of termination of his services prior to retirement or death, the amount of such employee's contributions which have been deducted from his salary by the employer each year shall be included in his gross income for Federal income tax purposes. In view of the fact that the employee acquires a vested valuable interest in the fund in the year his contribution is made, the situation is the same, from the standpoint of Federal income taxation, as if he had received in cash the amount paid over to the fund for his benefit.

Furthermore, the Service held that, where participation in the plan is voluntary and the employee is required to forfeit his own contributions should his services be terminated prior to retirement or death, the amount of the employee's contributions which have been deducted from his salary by the employer must be included in his gross income. In this latter case, from the standpoint of Federal income taxation, the employee has voluntarily directed that a part of his salary be paid under the plan in order to procure for himself or his beneficiaries the benefits of such plan.

In Revenue Ruling 72-94, 1972-1 C.B. 23, the Service considered the inclusion in gross income of amounts deducted from compensation as contributions by an employee participant under an employees' nonqualified pension plan where participation was compulsory and contributions were forfeitable. A number of states and municipalities had, by virtue of an ordinance or a statute, established nonqualified pension or retirement plans for their employees. In many of these plans, participation was compulsory and the employees were required to contribute a certain percentage of their compensation to the trust forming a part of the plan. Contributions were made by deduction from the employees' periodic pay checks. In some cases, the statute specifically provided for the forfeiture of all or a part of the employees' contributions upon termination of employment prior to retirement, death, or before completion of a stated length of service. In other cases, the statute was silent as to a refund of contributions in such an event. Thus, Revenue Ruling 72-94 considered a hybrid (compulsory but forfeitable contributions) of the fact patterns considered in Revenue Ruling 57-326.

Initially, Revenue Ruling 72-94 clarified the Service's holding in Revenue Ruling 56-473. The alternative (but not mutually exclusive) rationales for including compulsory contributions in an employee's gross income for the year in which deducted were the employee's implied consent to the contributions and the contribution's nonforfeitable character. While it appears that the holding in Revenue Ruling 56-473 is based only on the ground that the employee, by accepting employment with the state, "impliedly consents to the withholding of a part of his compensation," Revenue Ruling 72-94 justifies the result by the fact that the contributions are nonforfeitable because the deducted contributions "are held by a retirement board and become available to the employee only when the employee terminates his employment with the state and withdraws his contribution." Thus, Revenue Ruling 72-94 shifts the rationale for inclusion in the employee's gross income from the employee's implied consent to the contribution's nonforfeitable character. While clarified, the holding in Revenue Ruling 56-473 was nonetheless ratified.

Revenue Ruling 72-94 concludes that where, under an ordinance or statute of a municipality or state or the rules of a governing body of an organization establishing an employees' nonqualified pension or retirement plan, participation is compulsory and the ordinance, statute, or other rules (1) require the employee to forfeit his contributions in the event of termination of service prior to death or before becoming eligible for retirement, or (2) are silent as to the refund of employee contributions and, in the administration of the plan, no refund will be made in such event, the amounts withheld from the salary of an employee as contributions to the plan and applied solely to provide deferred pensions are to be treated as employer contributions. Accordingly, it was held that those contributions were not required to be included in the employee's gross income for the year in which so contributed. Consistent with the Service's earlier ruling in Revenue Ruling 57-326, Revenue Ruling 72-94 also provides that where only a portion of the contributions is required to be forfeited in the event of the termination of the employee's services, amounts not subject to forfeiture are required to be included in the employee's gross income each year.

The Service's holdings in Revenue Ruling 56-473, Revenue Ruling 57-326, and Revenue Ruling 72-94 are consistent with the holdings and rationales of courts which have considered whether compulsory contributions to state retirement plans are properly characterized as employer contributions or as employee contributions, <u>see Howell v. United States</u>, 775 F.2d 887 (7th Cir. 1985) (holding that compulsory 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); <u>Zweiner v. Commissioner</u>, 743 F.2d 273 (5th Cir. 1984) (holding that compulsory, nonforfeitable contributions to a state retirement plan having refund rights and benefits comparable to those of the federal civil service system are employee contributions taxable as current income in the same manner as federal employee contributions); <u>Feistman v. Commissioner</u>, 63 T.C. 129 (1974) (stating that "it has been established for many years that [compulsory contributions] withheld from salary and contributed to the applicable system are includible in the employee's currently reportable gross income"); and <u>Feistman v. Commissioner</u>, 35 T.C.M. 1045 (1976) (addressing subsequent years and concluding that "[t]he principles which dictate the result when applied to the civil service system dictate the same conclusion when applied to the provisions of the [California] retirement systems involved herein.") Thus, compulsory, nonforfeitable contributions which are designated as employee contributions are properly characterized as employee contributions rather than employer contributions for income tax purposes.

In Revenue Ruling 72-250, 1972-1 C.B. 22, the Service ratified its position that the portion of a United States Government employee's compensation that is withheld and contributed to the United States Civil Service Retirement and Disability Fund is a contribution by the employee to such fund and is includible in his gross income in the same taxable year in which it would have been included had it been paid to him directly. Similar contributions were held to be employee contributions includible in the employee's gross income in <u>Taylor v. Commissioner</u>, 2 T.C. 267 (1943), affirmed sub nom. <u>Miller v. Commissioner</u>, 144 F.2d 287 (4th Cir. 1944) (stating that "at least to the extent that it consists of contributions by the employee out of his basic salary, the payment provided by the Retirement Act is a true annuity comparable to one which might be subscribed for by any employer for the benefit of an employee and that it follows that if under such circumstances an employee on a cash basis is chargeable with the contribution to the cost of such an annuity made out of his salary, these petitioners were required to include the amount of the disputed withholding in their taxable income."); Megibow v. Commissioner, 21 T.C. 197 (1953), affd. 218 F.2d 687 (3rd Cir. 1955) (concluding that "the cases . . . which the petitioner cites for the proposition that mandatory withholdings from the pay of an employee for deposit in a pension fund actually represent contributions by the employer, are not accepted as authority for the proposition that this part of the petitioner's salary was not taxable to him under the provisions of the Internal Revenue Code."); Cohen v. Commissioner, 63 T.C. 267 (1974), affd per curiam, 543 F.2d 725 (9th Cir. 1976) (holding that "whether the plan created by the Civil Service Act was a qualified plan or a nonqualified plan, the amount withheld from the employee's salary to be put into the plan constitutes current income to the employee in the year of the withholding."); Hogan v. United States, 367 F. Supp. 1022 (E.D. Mich. 1973), affd. 513 F.2d 170. (6th Cir. 1975), cert. denied, 423 U.S. 836, 96 S.Ct. 62 (1975).

Congress subsequently endorsed and codified the characterization of compulsory contributions as employee contributions with the enactment of section 414(h)(1) as part of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406 (Sept. 2, 1974) (ERISA). Code section 414(h)(1) provides that an amount contributed to an employees' trust described in section 401(a) will not be treated as having been made by the employer if it is designated as an employee contribution.[2] While the statutory designation test of section 414(h) does not literally apply to nonqualified plans, the legal principles embodied in section 414(h) do. The legislative history to ERISA provides the following explanation regarding the significance of designating a contribution as either an employer contribution or an employee contribution under the plan:

> Designated contributions.–Under present law, contributions which are designated as employee contributions are generally treated as employee contributions for purposes of the Federal tax law. For example, this is the case with respect to employee contributions under the Federal Civil Service plan. Your committee's bill contains a provision to clarify this rule for the future. This provision provides that amounts that are contributed to a qualified plan are not to be treated as an employer contribution if they are designated as employee contributions.
>
> This provision gives effect to the source of the contributions, as designated in the plan. For example, if the appropriate committees of the Congress were to report legislation regarding employee contributions under the Federal Civil Service plan so that the present employee's contributions would become employer contributions under the Federal Civil Service plan (and that legislation were to be enacted), then those contributions would constitute employer contributions to the plan, which would be excludible from the employee's income when made. The same

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[2] Section 414(h)(2) provides an exception to the general rule stated above for state or local pick up plans. In such plans, certain governmental units or agencies pick up what would otherwise be an employee contribution by not withholding the employee contribution from the employee's salary. The amount picked up is treated as an employer contribution under section 414(h)(2).

> rule would apply to State and local governmental plans which now designate contributions as employee contributions, if the appropriate governmental bodies change the provisions of their plans.

H.R. Rep. No. 93-807, 93rd Cong., 2nd Sess. 145 (1974),1974-3 (Supplement) C.B. 380.

In accordance with the forgoing administrative, judicial, and legislative authority, the following three factors are relevant in determining whether compulsory contributions made pursuant to a nonqualified defined contribution plan and used to purchase retirement annuity contracts are employer contributions or employee contributions for purposes of section 403(b) and section 3121(a)(5)(D): 1) whether the contributions are compulsory under state or local law or are otherwise a condition of employment; 2) whether the contributions are designated as employee contributions and are deducted from the employee's base pay, salary, or compensation; and 3) whether the contributions are fully vested and nonforfeitable when credited to the employee's retirement account.

On the facts presented, all unclassified employees working half time or more in a benefits-eligible position are required by State statute to participate in the Plan and to be covered by a valid retirement annuity contract issued by a life insurance company designated by Taxpayer. Failure of an eligible employee to participate is cause for the employee's immediate termination. State statute also explicitly requires that eligible employees contribute X% of their base salaries as fixed by Taxpayer towards the purchase of retirement annuity contracts.[3] In contrast to these designated employee contributions, Taxpayer has an independent statutory obligation to make an employer contribution towards the purchase of a retirement annuity equal to Y% of the employee's base salary. Finally, each employee's rights in the retirement annuity contract are fully vested and nonforfeitable at the time of the contribution.

In accordance with the forgoing analysis, we conclude that, absent a legally binding salary reduction agreement, compulsory contributions made pursuant to the Plan and used to purchase retirement annuity contracts do not constitute employer contributions for purposes of section 403(b) and section 3121(a)(5)(D).

We must next determine whether compulsory contributions made pursuant to a legally binding salary reduction agreement constitute employer contributions for purposes of section 403(b) and section 3121(a)(5)(D). In Revenue Ruling 70-582, 1970-2 C.B. 95, the Service considered whether contributions by a state college to purchase a retirement annuity pursuant to a salary reduction agreement, where a state statute required employee contributions toward retirement and permitted such

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[3] Each unclassified employee's base salary is set forth in a contract of appointment executed on an annual basis. Unclassified employees who are not required to participate in the Plan receive the entire amount of the base salary set forth in their contract of appointment. Employees who are required to participate in the Plan receive only the excess of their base salary over the amount of their compulsory contributions. Thus, the compulsory contributions are deducted from amounts Taxpayer would otherwise be obligated to pay the employees pursuant to their contracts of appointment.

contributions by salary reduction agreements or salary deductions, constituted employer contributions for purposes of section 403(b). The state statute required a contribution of a specified percentage of the annual compensation of employees of state educational institutions toward the employees' retirement. The statute provided that each educational institution would determine whether contributions for its employees would be made by means of a deduction (withholding) from the employees' salary or by means of salary reduction agreements.

Pursuant to this statute, a state college entered into an agreement with one of its faculty members whereby the member's salary was reduced and the amount of the reduction was applied by the college toward the purchase of a nonforfeitable, nontransferable individual annuity contract. Citing section 1.403(b)-1(b)(3) of the Income Tax Regulations, the Service held that the exclusion provisions of section 403(b) were applicable to the reduction agreement and, consequently, that the compulsory contribution constituted an employer contribution by operation of the salary reduction agreement. Thus, Revenue Ruling 70-582 illustrates that employers and employees may enter into legally binding salary reduction agreements notwithstanding a statutory mandate requiring employee contributions.

In University of North Dakota v. United States, 603 F2d 702 (8^{th} Cir. 1979), the court considered whether contributions made by the University of North Dakota to the North Dakota State Employees Retirement Program pursuant to salary reduction agreements constituted wages subject to withholding under section 3401(a)(12)(A) (for purposes of income tax withholding at source on wages.) The North Dakota statutes governing the plan required both employers and employees to make contributions to the plan. For the years at issue, the university employees executed salary reduction agreements pursuant to which each employee's salary was reduced by the amount of his contribution to the plan and the university's contribution was increased by a like amount. The sole purpose of these salary reduction agreements (as found by the court) was to defer taxation on all contributions made to the plan.

The university contended that the increased contributions were employer contributions and, thus, were not wages subject to withholding under section 3401(a)(12)(A). Conversely, the Government contended that because state law required employee contributions to be withheld from the employees' pay, the additional amounts transmitted by the University pursuant to the salary reduction agreements constituted wages subject to withholding (i.e., remained employee contributions notwithstanding the salary reduction agreements.) In effect, the Government contended that the salary reduction agreements were ineffectual with respect to the employees' compulsory contributions. The court concluded, however, that the precise manner in which mandatory contributions were made fell within the administrative discretion of the state board. Salary reduction agreements authorized by the state board altered the provision of the plan so that the contributions were designated as employer contributions.

> The effect of the district court's holding is that the appropriate governmental body, i.e., the State Board, has altered the provisions of the Plan by the salary

> reduction agreements so that the challenged contributions now are designated as employer contributions.

University of North Dakota v. United States, 603 F2d 702 (8th Cir. 1979)

Thus, if an employee enters into a legally binding salary reduction agreement, a compulsory contribution that would otherwise be taxable as an employee contribution may be treated as an employer contribution if such characterization is consistent with statutory intent.

In Public Employees' Retirement Board v. Shalala, 153 F.3rd 1160 (10th Cir. 1998) the court considered whether contributions to a retirement plan made by the state of New Mexico for its employees after a corresponding reduction in the employees' gross salary were made pursuant to a salary reduction agreement where the contributions were mandated by State statute. Though the court was considering mandatory contributions in the context of a section 414(h)(2) pick up plan and salary reduction agreements for purposes of section 3121(v)(1)(B), both section 3121(a)(5)(D) and section 3121(v)(1)(B) refer to contributions made by reason of "a salary reduction agreement (whether evidenced by a written agreement or otherwise)."

The State contended that a salary reduction agreement excludes arrangements in which the employees' participation in the salary reduction plan is mandated by state statute.[4] The court concluded, however, that, for purposes of 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." While the court's reasoning turned on the mandatory nature of a pick up plan under section 414(h)(2), a similar reading of substantially identical language under section 3121(a)(5)(D) is completely consistent with the purpose of that provision.

As indicated above, the Service and the courts have recognized that a legally binding salary reduction agreement converts a compulsory contribution from an employee contribution to an employer contribution by reducing the amount otherwise owed as salary by the employer to the employee. In the absence of a legally binding salary reduction agreement, the compulsory contributions must constitute employee contributions for Taxpayer to satisfy its salary obligations under the appointment contracts. A legally binding salary reduction agreement reduces Taxpayer's salary

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[4] The State was able to assert this argument because the designated employee contributions were treated as employer contributions for income tax purposes pursuant to section 414(h)(2). Consequently, no salary reduction agreement was needed to convert the employee contributions into employer contributions. Pursuant to section 403(b), however, compulsory employee contributions are treated as employer contributions for income tax purposes only by operation of a legally binding salary reduction agreement. The salary reduction agreement that converts compulsory employee contributions into employer contributions for purposes of section 403(b) also causes the resulting employer contributions to be characterized as wages pursuant to section 3121(a)(5)(D).

obligations under the appointment contract, thereby allowing the contributions to be treated as employer contributions on a dollar-for-dollar basis. It is the amount of the salary reduction, no longer owed to the employee, that funds the employer's supplemental contributions to the plan.[5]

Both Revenue Ruling 70-582 and University of North Dakota demonstrate that compulsory employee contributions (mandated by statute) may be converted to employer contributions by operation of a legally binding salary reduction agreement. Specifically, with respect to retirement annuity contracts described in section 403(b), Revenue Ruling 70-582 authorizes treating compulsory employee contributions as employer contributions pursuant to a salary reduction agreement. In Public Employees' Retirement Board the designated employee contributions were treated as employer contributions by operation of a section 414(h)(2) pick up, but the mandatory contributions were nonetheless determined to be made pursuant to a salary reduction agreement for purposes of section 3121(v)(1)(B). Consequently, we conclude that compulsory contributions made pursuant to a legally binding salary reduction agreement constitute employer contributions for purposes of section 403(b) and section 3121(a)(5)(D).

In Revenue Ruling 2000-35, 2000-2 C.B. 138, the Service considered whether contributions used to purchase an annuity contract described in section 403(b) and made pursuant to an elective deferral arrangement are properly treated as having been made pursuant to a salary reduction agreement. Citing section 1450(a) of the Small Business Job Protection Act of 1996, the Service stated that the frequency with which salary reduction agreements may be entered into, the salary to which such agreements apply, and the ability to revoke such agreements will be determined under the rules applicable to cash or deferred elections. Thus, with respect to elective deferral arrangements, the provisions of section 1.403(b)-1(b)(3) relating to salary reduction agreements were superceded by the provisions applicable to cash or deferred elections.

A cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to a plan that is intended to satisfy the requirements of section 401(a). A cash or deferred election is any election by an employee to have an employer either provide an amount to the employee in the form of cash or contribute an amount to a trust under a plan deferring the receipt of compensation. Thus, a cash or deferred election requires that the employee have an election between the employer paying cash to the employee or making a contribution to a trust on behalf of the employee. Consequently, a cash or deferred election does not include compulsory contributions.

Revenue Ruling 2000-35 relates to salary reduction agreements under elective deferral arrangements. Compulsory contributions are not made pursuant to elective deferral arrangements. Rather, compulsory contributions are analogous to designated

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[5] As discussed above, section 414(h)(1) precludes the use of salary reduction agreements to convert designated employee contributions into employer contributions under certain circumstances.

employee contributions under section 414(h)(1). The application of Revenue Ruling 2000-35 to compulsory contributions would preclude making compulsory contributions pursuant to a salary reduction agreement and, consequently, would preclude treating compulsory contributions as employer contributions for purposes of section 403(b) and section 3121(a)(5)(D). Compulsory contributions are not made pursuant to a cash or deferred election and can be made pursuant to a salary reduction agreement for purposes of section 403(b). Consequently, Revenue Ruling 2000-35 does not apply to compulsory contributions made pursuant to salary reduction agreements.

Finally, we must determine whether the salary reduction agreements entered into by and between Taxpayer and its eligible employees constitute legally binding salary reduction agreements. While State statute requires employees to contribute X% of their base salaries to the plan, it contemplates that the contribution will be made on a "pretax basis." The only method for converting compulsory employee contributions towards the purchase of a retirement annuity contract into employer contributions is a salary reduction agreement. Additionally, the resolution describing the provisions of the retirement plan authorized by law and established by Taxpayer specifically provides that Plan contributions by a participant will be made "on a tax-deferred basis under an agreement for salary reduction executed in accordance with section 403(b) of the Internal Revenue Code." The salary reduction agreement itself specifically provides that Taxpayer "is authorized and directed to reduce my compensation to purchase for me a non-forfeitable annuity or annuities as hereinafter described." Finally, the salary reduction agreement provides that "[T]his agreement shall be legally binding and irrevocable as to both the parties hereto while employment continues" and is signed by both the employee and Taxpayer.

Conclusion

We conclude that, based on State statute, the Plan documents, and the salary reduction agreement entered into between each employee and Taxpayer, a legally binding salary reduction agreement was intended and was in fact entered into. Consequently, pursuant to those legally binding salary reduction agreements, compulsory contributions that would otherwise be employee contributions are properly characterized as employer contributions for purposes of section 3121(a)(5)(D). As employer contributions made by reason of salary reduction agreements, the contributions are includible in wages for FICA tax purposes.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Additionally, this ruling is directed only to the taxpayer requesting it. Code section 6110(k)(3) of the provides that it may not be used or cited as precedent.

The rulings contained in this letter are based on information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,
Lynne Camillo
Branch Chief, Employment Tax Branch 2
Office of CC:TEGE:EOEG:ET2

Enclosure

cc: