How Do You FICA?

Jessica Miller

KLC Training Manager/Attorney

I will never forget receiving my first "real" paycheck as a dishwasher at a restaurant in my hometown. While I had been unofficially working in the steamy kitchen for as long as I could remember, my "check" usually came in the form of an allowance after my mother cashed her own paycheck (she was the manager). When I turned 15, my pay came in a fancy windowed envelope with a little stub that told me where all my hard-earned money went, and to my surprise, most of it did not go to me. Included on that stub was this guy named FICA. My mother tried to explain the what and why of the tax deductions, but it did not soften the blow that Mr. FICA was getting a large chunk of *my* $5.25 an hour.

Fast-forward 15 years and I still don't quite understand the mystery around FICA, but I do know that it is not a person but rather, the Federal Insurance Contributions Act (FICA). According to the official Social Security website, this deduction is an amount paid by individuals during the period in which they earn wages for purposes of providing them with benefits when they retire. Social Security benefits are made available to retired workers, their spouses and their dependents as well as to disabled workers, their spouses and their dependents. FICA tax is also known as the Social Security tax.

In 2014, rumblings out of Frankfort suggested that Kentucky may be facing compliance issues related to the way that the state had been collecting its Social Security taxes. In its calculation of Social Security and Medicare tax liabilities, Kentucky had been using the following formula: Total Wages - Employee's Pension Contributions = Taxable FICA Wages. Unfortunately, this is not the correct formula for calculating tax liability. Rather, the state should have been including the employee's pension contributions in taxable wages. So how in the world did this happen? To understand the problem, we need to understand some basic history relating to these benefits.

In 1974, Congress added section 414(h) to the *U.S. Internal Revenue Code*, which provided a tax break to governmental employers by removing state pension contributions from an employee's gross income until such time they were distributed by pension systems. The legislation exempted these payments if the employer deducted and paid the pension contributions directly to the retirement system, or to use industry terminology, if the employer "picked up" the contributions.

Remember, employer contributions are not included within "gross income" so they are not subject to FICA or income taxes, but employee contributions are subject to both forms of taxation. As a result of Section 414(h), many governmental employers, including the Commonwealth, opted to "pick up" the contributions of their employees for the tax benefit. In

1983, after noticing the trend, Congress added a provision to the *Code* that clarified that any "picked up" amounts would be treated as employer contributions under 414(h)(2) and thus treated as FICA wages subject to FICA taxes.

From 1987 until 2014, when calculating FICA tax liability, Kentucky governmental employers continued to use the calculation that exempted pension contributions because of IRS Private Letter Ruling #871803, that states that under Kentucky statutes retirement holdings were not wages that had to be included for purposes of calculating FICA taxes provided they were not "picked up" pursuant to a salary reduction agreement.

A great deal of the confusion around this topic comes from misinterpretation of key terms associated with the calculation including what "picked up" and "salary reduction agreement" mean. These terms have been defined through case law and private letter rulings from the IRS. Contributions are considered "picked up" by the employer under Section 414(h)(2) if two criteria are satisfied. First, the employer must specify that the contributions, even though designated as "employee contributions," are being paid by the employer in place of employee contributions. The second criterion is that the contributions by the employer are mandatory and the employee does not have the option of receiving the amounts directly as wages instead of having them paid to the pension plan.

A "salary reduction agreement" 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. This "agreement" does not mean an individual negotiated contract, but rather can be mutual assent to the arrangement.

In 1998, a very important legal case out of New Mexico further defined the 1983 legislation and emphasized the correct withholding calculation included all employee contributions to their pension. [*Public Employees' Retirement Board v. Shalala*, 153 F.3d 1160, 1162 (1998)]. Since this case the IRS has been systematically addressing and reversing the Private Letter Rulings that states have been relying upon in their calculations. In 2014, Kentucky's number was up and IRS officials told state officials that the Private Letter Ruling was no longer valid and that employee pension contributions had to be included for calculating FICA tax liability.

Since learning of the calculation error in 2014, Kentucky has negotiated with the IRS on how to comply with the rule. Kentucky was asked to prepare a reasonable plan to change the treatment of pension contributions to bring the state into compliance for calculating FICA and Medicare contributions effective December 31, 2015. Through a series of negotiations, the state has resolved this issue by contractually assuring that no past liability would be owed by any governmental entity and that the new calculation would be effective January 1, 2017. The state has entered into a Memorandum of Agreement with the IRS that as of January 1, 2017, taxable FICA wages will include the employees' pension contributions, but the employer will continue to deduct cafeteria plan expenditures. This period gives agencies adequate time to plan for a new budgeting process, to make necessary changes in payroll systems and to

communicate with all those who will be impacted, which includes employers and employees. This settlement affects virtually all governmental employers including executive, legislative and judicial branches of state government; all eight of the state universities, including the community and technical college system; and the 1,471 counties, cities and local school districts. The state estimates that the additional annual cost will be approximately $5.7 million for state government agencies alone.

There is a silver lining in all this mess - for impacted governmental employees, the additional contributions will result in increased Social Security benefits upon retirement.

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