



Employer "Pick-Up" Contributions to Benefit Plans

Retirement plans that feature a salary reduction or cash-deferred arrangement allow employees to choose to defer some income from tax by electing to place it in a trust account for retirement. By making such an election, the amount deferred is not subject to income tax at the time it was placed in the trust. The deferred amounts are subject to social security and Medicare (FICA) tax.

However, other employer retirement plans are funded either through employer contributions only, or by mandatory employee contributions, with no elections to defer salary. These plans can raise questions about whether the contributions are considered paid by the employer or by the employee, and thus whether these amounts are subject to income tax and FICA withholding. This article is intended to address recent IRS guidance on these questions.

General Rule for Employee Contributions

Contributions made by the employer to an employee retirement plan (whether the plan provides for elective deferrals or not) are not included in employee income. However, any additional contributions made by the employees are included in income, unless they are made under elective deferral provisions. Where no deferral election is possible (such as in a defined benefit plan), employee contributions are included in income. In general, any employer contributions made by an employer to a 401(a) or 403(b) plan on behalf of employees are not treated as made by the employer if they are designated as an employee contribution.

Employer Pick-up

However, IRC section 414(h)(2) provides that for any plan established by a governmental unit, where the contributions of employing units are designated employee contributions, but the employer "picks up" the contributions, the contributions are treated as employer contributions.

For the employee contributions to be deemed picked up by the employer and therefore to be characterized as "employer contributions", certain tests must be met. A series of rulings by the IRS established that only amounts that the governmental employer pays (including certain amounts withheld or otherwise offset from the employee's salary) are considered employer contributions, and are therefore excludable from gross income.

In Revenue Ruling 2006-43, the IRS clarified the requirements for employee contributions to be considered made, or picked up, by the employer.

- Specifies that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions.
- Does not permit a participating employee, from and after the date of the "pick-up", to have a cash or deferred election right with respect to designated employee contributions. Participating employees must not be permitted to opt out of the "pick-up", or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Further details of these requirements are contained in Revenue Ruling 2006-43.

Treatment of Contributions for Social Security and Medicare Tax

The above applies to the income tax treatment of employer pick-ups. In CCA 200714018, the IRS addressed the treatment of pick-ups for social security and Medicare tax (FICA) purposes.

Contributions to a retirement plan that come from salary reduction amounts are subject to FICA. IRC 3121(v)(1)(B) indicates that a salary reduction occurs if the amount shown as wages are less than they would have been but for the contribution.

In order for contributions to be considered paid by the employer, and therefore not subject to FICA, the employer contributions:

- Must be mandatory for all employees covered by the retirement system.
- Must be a salary "supplement" and not a salary reduction – in other words, the employer must not reduce employee salary to offset the amount designated as employee contributions.

The amounts that would have been included in wages for FICA tax purposes "but for the employee contribution" are determined based on the facts and circumstances that determine the employee's compensation under the overall employment relationship. If the circumstances indicate that the wages are equal to what they otherwise would have been, but for the contribution, then the amounts are not included in FICA wages. If the facts and circumstances indicate that the contributions reduced or offset the wages paid, they would not meet the test and the contributions to the plan and would be included in FICA wages.

If the employer pays the contributions in addition to salary increases that are consistent with historical norms, this is an indication that they are not paid in lieu of present or future salary and are not included in wages for FICA purposes.

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