

March 31, 2005 (updated April 19, 2005)

Federal Update 2005-10

TO: NCTR Members

FROM: Cindie Moore, Washington Counsel

RE: Repeal of Pick Ups Included in Congressional Proposals

Introduction

The staff members of the Joint Committee on Taxation (JCT) have presented options for changing the tax treatment of pensions and other provisions of the Internal Revenue Code. The JCT staff member's publication, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (2005), contains five options that directly affect state and local government (SLG) retirement and other benefit plans. Other options in the publication affect such entities as individuals, corporations, and tax-exempt organizations. The JCT's role is, among other activities, to investigate the operation and effects of tax statutes and their administration.

The JCT staff members characterize the publication as a means to put forward ways for improving tax compliance and reforming tax expenditures. They point out that the options would curtail tax shelters, close unintended loopholes, and address other areas of noncompliance in present law. In addition, each of the options will likely raise revenue.

The options, an independent work-product of the JCT staff members, have not received prior approval of the Chairman of the Senate Finance Committee, Charles Grassley (R-IA), or the Ranking Democrat, Max Baucus (D-MT), or their staffs. Senators Grassley and Baucus requested the JCT staff members to draw up the options.

The option with the greatest potential effect on SLG plan design is the proposed repeal of the employer pick-up. I summarize the JCT staff members' analysis of the repeal, then briefly describe the other four options. I also provide the amount of revenue raised between 2005 and 2014 by each option. For more detail, go to <http://www.house.gov/jct/s-2-05.pdf>.

➤ **Repeal Pick-Up Rules for Employee Contributions to State or Local Governmental Retirement Plans (pp. 140-144)**

Eliminate the right of SLGs to pick up (i.e., pay) employee contributions. Thus, employee contributions would be included in income and would be wages for FICA purposes.

Under current law, the basic rule of taxability applies to employer and employee contributions as follows:

- Employer contributions are NOT includible in employees' income at the time of contribution and NOT considered wages for FICA purposes, even though for state law purposes the amount is still deemed to be an employee contribution.
- On the other hand, employee contributions ARE includible in employees' income at the time of contribution and ARE wages for FICA purposes.

If a pick up is in effect, the treatment of employer contributions for income tax and FICA purposes is the same. Employee contributions, however, are NOT includible in employees' income at the time of contributions. Whether the picked up amounts are wages for FICA purposes depends on the type of pick up.

Regardless of whether an employee contribution is picked up or not, if a state or local government does not participate in Social Security, FICA is not an issue.

Seventy-five percent of contributory SLG plans pick up their employee contributions. *Survey of State and Local Government Employee Retirement Systems, Public Pension Coordinating Council (2000) at 52.*

The JCT staff members provide three rationales for their proposal:

- The pick-up is not available to contributions made by employees of private employers or employees of the federal government. Thus, according to the JCT staff members, the proposal "furthers consistency in the tax system."
- Application of the pick-up rules to employee contributions to defined contribution plans could be a means of avoiding the requirements applicable to elective deferrals.
- The pick-up rules are complex for two reasons: 1) whether contributions are eligible for pick-up treatment (as evidenced by the number of IRS rulings in this area) and 2) with respect to whether pick-up contributions are made pursuant to a salary reduction agreement and are thus subject to FICA tax.

The JCT staff members acknowledge the following possible outcomes if the proposal passes:

- Increased income taxes for participants in affected SLG plans with respect to employee contributions that are no longer eligible for pick-up treatment and thus includible in income;
- Need for some SLGs to redesign their plans so that contributions that are currently designated as employee contributions are instead treated as employer contributions (in which case, such employer contributions would not be includible in employees' income or wages for FICA purposes);

- Need for participants to determine the portion of a distribution that is includible in income; and
- Need for plan administrators to keep records on after-tax employee contributions.

Revenue raised: \$4.8 billion

Provide Consistent FICA Treatment of Salary Reduction Amounts (pp. 71-73)

Make consistent the treatment of salary reduction amounts for FICA (that is, the Social Security payroll) purposes. At present, contributions to tax-favored retirement plans, such as 401(k)s are wages, for FICA purposes. Other salary reduction amounts, such as contributions to cafeteria plans, are excluded from wages for FICA purposes.

Revenue raised: \$164 billion

➤ Extend Medicare Payroll Tax to All State and Local Government Employees (pp. 80-82)

Require all state and local governments and their employees, without regard to their dates of hire or participation in a retirement system, to pay the Medicare payroll tax (also known as the Hospital Insurance (HI) tax). At present, state and local government employees hired on or before March 31, 1986 and who are not covered by Social Security, do not pay the Medicare payroll tax. Neither do their employers. In addition, state and local government employees who were not covered under a retirement system or Social Security had to begin paying the tax for services performed after July 1, 1991, as did their employers.

Revenue raised: \$5.4 billion

➤ Provide Greater Conformity for Section 403(b) and Section 401(k) Plans (pp. 122-129)

Conform rules for section 401(k) and section 403(b) plans by eliminating some of the special rules applicable to section 403(b) plans as follows:

-repeal the rule permitting contributions to a section 403(b) plan for an employee for up to five years after termination of employment, thereby conforming the definition of compensation applicable to section 403(b) plans for the purpose of the limit on annual additions to the definition of compensation applicable to defined contribution plans generally, including section 401(k) plans; and

-eliminate the rule for section 403(b) plans that permit employees who have completed 15 years of service with certain employers to make additional elective deferrals.

This option also makes certain changes in the nondiscrimination rules, which do not apply to SLGs.

Revenue raised: \$800 million

➤ **Extend Early Withdrawal Tax to Eligible Deferred Compensation Plans of State and Local Governments (pp. 130-132)**

Make the 10% early withdrawal penalty tax applicable to participants in section 457 deferred compensation plans. At present, taxable distributions made before age 59 ½, death, or disability are generally subject to an additional 10% income tax unless an exemption applies. This early withdrawal tax applies to all taxable distributions from tax-favored retirement arrangements, except distributions from an eligible retirement plan (that is, a section 457 plan) of a tax-exempt or SLG employer. Thus, such tax applies to taxable distributions from such arrangements as section 401(k) and section 403(b) plans, traditional IRAs, and Roth IRAs.

Revenue raised: \$1.5 billion