MEMORANDUM OF LAW

DATE: May 25, 1988

TO: Joe Lozano, Assistant Auditor and Comptroller
FROM: City Attorney
SUBJECT: Medicare Tax Withholding Requirements

You have recently asked this office several questions concerning the requirement to withhold medicare tax from certain City benefits for employees subject to the medicare tax (i.e., employees hired after March 31, 1986). You also asked if there has been any recent change in the law which affects the advice contained in our June 9, 1986 memorandum of law concerning medicare withholding requirements. We will answer your questions seriatim with the exception of question no. 5 which we will answer together with question no. 1 because they are interrelated.

QUESTION NO. 1

Are deferred payments to retirees for accrued annual leave made pursuant to Administrative Regulation 95.90 subject to medicare withholding? If they are, when should the withholding and reporting take place? Should it be a lump sum at retirement or annually as payments are made?

QUESTION NO. 5

Is the medicare withholding tax calculated on wages before or after voluntary employee contributions to deferred compensation/401(k) plans?

ANSWERS TO QUESTIONS NOS. 1 & 5

City of San Diego Administrative Regulation 95.90, effective December 15, 1981, promulgates eligibility standards and procedural guidelines for the accrual and reimbursement of unused sick leave and annual leave upon retirement. Paragraph 4.3, entitled "Retiree Options" states as follows:

a. Retiring employees may request one of the following options to receive payment for accrued, unused sick leave or annual leave, with the final decision on the payment option to be made by the City:
   (1) One full payment upon retirement.
   (2) One full payment at a specified date with 365 days of retirement.
   (3) Three or five annual payments, the first portion of the total amount to be paid upon retirement and the ensuing payments

> in January of the next two or four successive years. Payments need not be equal amounts. Under the multi-payment option, no interest is paid to the retiree on funds held for future payment. The employee may not transfer his/her interest in funds as collateral on loans, etc.

As we have previously stated to you, the Internal Revenue Service (IRS) announced in IRS Notice 87-13 that the contribution limitations of section 457 of the Internal Revenue Code (i.e., $7,500 per year) included the cash value of certain nonelective deferred compensation such as vacation leave, sick leave, compensatory time off, severance pay, disability pay or death benefit plans. On January 25, 1988, the IRS issued Notice 88-8. That notice announced that the IRS will attempt this year to develop rules clarifying the position taken in Notice 87-13 but that nonelective deferred compensation will not be subject to the provisions of section 457 for taxable years of employees beginning before January 1, 1988. As usual, the IRS states that no inference may be drawn from this notice as to the possible future treatment of such benefits under section 457. The notice simply announces that they are currently studying a number of issues raised by their recent interpretation of section 457 and that further guidance will be provided at a later date.

Furthermore, IRS Letter 87-46023 issued this past year proclaims that the amounts set aside under a deferred compensation agreement, although not subject to income tax, are subject to social security and medicare taxes when earned or when substantial risk of forfeiture ceases. This appears consistent with the legislative history of section 324(a)(1) of the Social Security Amendments of 1983 which added section 3121(v) to the

Internal Revenue Code. That section discusses the tax treatment of certain deferred compensation and salary reduction arrangements for the purposes of calculating the wage base for social security and medicare tax purposes.

Although section 3121(v)(3) may appear on its face to exempt governmental deferred compensation plans from these taxes, in effect, it does not. Section 3121(v)(3) states in part:

> For purposes of subsection a(5), the term "exempt governmental deferred compensation plan" means any plan providing for deferral of compensation established and maintained for its employees by the United States, by a State, or political subdivision thereof, or by

any agency or instrumentality of any of the foregoing. Such terms shall not include -

(A) any plan to which section 83, 402(b), 403(e), 457(a) or 457(f)(1) applies ....

Emphasis added.

Unfortunately section 457(a) applies to most governmental deferred compensation plans including The City of San Diego's deferred compensation plan. If the IRS eventually treats vacation and sick leave carryovers as a type of section 457 deferred compensation, the medicare tax will apply to those benefits for eligible employees.

The legislative history to the 1983 Social Security Amendments is helpful in understanding why the social security and medicare tax applies to amounts deferred under either section 457 or 401(k). The federal government is apparently concerned that employees can avoid paying social security and medicare taxes by deferring income into qualified deferred compensation plans. Senate Report 98-21 indicates the following at pages 40 through 41:

> Under the bill an employer's plan contributions on behalf of an employee under a qualified cash or deferred arrangement will be includible in a social security wage base for tax and coverage purposes to the extent that the employee could have elected to receive cash in lieu of the contribution ....
>
> In addition, amounts subject to an employee's designation under a cafeteria plan that includes a qualified cash or deferred arrangement will be includible in the social security wage base to the extent that such amounts may be paid to the employee in cash or property or applied to provide a benefit for the employee that is not otherwise excluded from the definition of "Wages" under section 3121 of the Internal Revenue Code.
>
> The bill would also include in the social security wage base amounts deferred under an eligible state deferred compensation plan (section 457(a)). The payment to such plan would be treated as wages received in the year in which the services relating to the payment were performed.

Based on the above, we believe that the benefits provided by Administrative Regulation 95.90 will eventually be treated as a type of section 457 deferred compensation. In other words, unused vacation will not only be subject to the medicare tax in the year it is earned for covered employees, but most likely it

will also be subject to the section 457 limitations. Currently, however, a reasonable interpretation of section 457, in the absence of further regulations, requires the withholding of medicare tax on annual leave payout balances only upon receipt by the employee of the benefit. This analysis also applies to those individuals who are eligible for the deferred leave payout benefit of Administrative Regulation 95.90, although at the present time the only employees covered by medicare who have any possibility of retiring in the near future are those members of the safety services who retire due to an industrial disability.

The effect of IRS Letter 87-46023 is more imminent. It requires the City to withhold medicare tax for applicable employees on all payments to the City's section 457 deferred compensation plan or 401(k) plan at the time the deferral is made.

We will notify you as soon as the unresolved issues concerning the tax treatment of nonelective deferred compensations are settled either by the Internal Revenue Service or by Congress. Hopefully, that will occur this year. We will then advise you of the impact of any changes on Administrative Regulation 95.90.

QUESTION NO. 2

We currently report the full amount of employee mileage reimbursements in gross wages for federal and state tax purposes. This is done because the City's 28-cents per mile reimbursement exceeds the federal limit of 22.5-cents. Are mileage reimbursements subject to medicare? If the full amount is not subject to medicare withholding, is the excess amount reimbursed by the City over the federal guidelines subject to Medicare withholding?

ANSWER TO QUESTION NO. 2

Section 3121a(20) excludes from the medicare tax benefits provided to or on behalf of an employee if at the time such benefits are provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132. Section 132 of the Internal Revenue Code excludes from a gross income certain fringe benefits. Subsection (d) defines working conditions fringes as follows:

> For purpose of this section, the term "working condition fringe" means any property or services provided to an employee of the employer to the extent that if the employee paid for such property or services such payment would be allowable as a deduction under section 162 or 167.

Revenue Ruling 87-93 states that if a reimbursement rate of 22.5-cents is used by the employer, no reporting of the reimbursed amount is required and therefore, the amount is not subject to medicare or income tax. Clearly 22.5-cents of the 28-cents reimbursement is excludable from gross income as a working condition fringe and is not subject to medicare withholding. However, the additional 5.5-cents, which exceeds 22.5-cents per mile, is subject to medicare tax only if the employee is unable to justify it as an unreimbursed business expense on the individual employee's return. Under these circumstances, we believe there is no requirement to withhold medicare tax out of the additional 5.5-cents reimbursement as along as the City continues to report the entire 28-cents as income.

QUESTION NO. 3

Per the attached Exhibit I, what effect, if any, does the sentence "Cafeteria plan cash options over $500 would be taxed to employees whether or not they choose the cash" have on our Flexible Benefits Plan (FBP) and Management Benefits Plan (MBP)? What happens if the yearly cash options under FBP and MBP total less than $500?

ANSWER TO QUESTION NO. 3

Attached to your letter was a December 11, 1987 Kiplinger tax letter that indicates that the cafeteria plan cash option over $500 would be taxed to employees whether or not they chose the cash. Fortunately in December 16, 1987 this measure was deleted from the Budget Reconciliation Act of 1987 (HR 3545, Public Law 100-203). However this idea may be resurrected in 1988 in a different form and if it is, we will advise you of any of its implications at that time.

QUESTION NO. 4

The City currently provides a $30 bus pass subsidy ($40 actual cost, $10 paid by the employee) to its employees. What amount, if any, would be taxable/reportable income for federal and/or state purposes? Would this also be subject to medicare withholding?

ANSWER TO QUESTION NO. 4

Pursuant to Internal Revenue Regulation 1.132-6T(d)(1), transit passes with a value of no more than $15 per month are exempt from gross income pursuant to section 132 of the Internal Revenue Code as a de minimis fringe benefit. Once this limit is exceeded, however, the entire amount is reportable income for federal and state tax purposes. This amount is also subject to medicare withholding. At the present time, however, Congress is considering raising this amount to $60 per month under Senate

Bill S.2023 introduced by Senator D'Amato of New York.

You also asked us if any recent changes of note had occurred since the issuance of our June 9, 1986 memorandum of law. We bring your attention to Internal Revenue Code section 132(h)(5) which now indicates that the term "working condition fringe" includes parking provided to an employee on or near the business premises of the employer and as such, is a nontaxable benefit not subject to medicare withholding.

We will continue to advise you of any relative changes in the IRS Code as soon as we have notice of them.

JOHN W. WITT, City Attorney
By
John M. Kaheny
Deputy City Attorney

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