

**MEMORANDUM**

**To:** Board of Regents  
**From:** Board Office  
**Subject:** Modification of Tax Consequences for University Retirement Contributions  
**Date:** October 9, 2000

**Recommended Action:**

Authorize the State University of Iowa, Iowa State University, and the University of Northern Iowa each --

1. To seek a private letter ruling from the Internal Revenue Service as to the requirement that FICA tax be paid on the employee's mandatory contribution to the university's defined contribution plan; and
2. To seek an Internal Revenue Service refund and appropriate interest for FICA payments made during tax years 1996 to present on each employee's mandatory contribution to the university's defined contribution retirement plan, to the extent appropriate after consultation with affected employees.

**Executive Summary:**

Iowa Code § 262.9(2) vests in the Board of Regents authority to fix the compensation of all Regent employees. This authority goes beyond salary and includes the benefits packages provided to Regent employees. The retirement program is one of those benefits. Currently, the Board permits employees to choose either participation in the Iowa Public Employment Retirement System (IPERS) or one of several alternatives to IPERS, including the most frequently selected alternative, Teachers Insurance and Annuity Association/College Retirement Equities Fund (TIAA/CREF).

The three Regent universities have received tax advice from the accounting firm of Deloitte and Touche (D&T), which indicates that the universities did not need to pay FICA tax contributions on the employees' share of their mandatory contribution to the universities' retirement programs offered as an alternative to IPERS. The universities have determined that seeking such a refund and ceasing to pay the FICA tax in the future is in the best interest of the universities

and their employees. The process for seeking the refund will be lengthy. First, the universities will have to secure a private letter ruling from the Internal Revenue Service (IRS) indicating that the FICA tax payment was not required. Second, the universities will have to consult with and receive permission from the affected employees (those who earn less than the maximum salary on which the FICA tax has been paid, plus approximately 5.3%) before their individual refunds can be sought.

The universities anticipate eliminating FICA tax payments on all future mandatory contributions by employees to the retirement programs offered as IPERS alternatives.

If an employee's salary is below the maximum salary on which FICA taxes are paid, the employee's Social Security income at retirement will possibly be affected. The universities' calculations indicate that if the employees save, with a modest rate of return, all of the money they do not pay in FICA taxes, they would experience no adverse affect, i.e., the savings with interest will more than offset the reduction in Social Security payments.

The Office of the Attorney General (AG) has reviewed the legal requirements of seeking the FICA tax refund. The AG counsels that the Board must approve the universities' efforts to proceed as indicated and that the law is not clear and direct in authorizing this proposed change, though no harm will result in requesting such a change.

#### **Background:**

The discussion which follows pertains only to the three Regent universities. The two special schools have chosen not to pursue this matter as a cost-benefit analysis indicated there would be no savings for them in pursuing the refund.

Regent employees are required to participate in a retirement program. The Board permits employees to choose between the IPERS retirement program and a variety of alternatives to IPERS, the most common of which is TIAA/CREF. The universities' efforts involve only the FICA tax on employee mandatory contributions to alternate retirement programs and do not pertain to employees who have elected IPERS as their retirement program. In approximate numbers, the affected employees are those who earn less than the maximum salary (currently \$76,400) on which the FICA tax has been paid, plus 5.26% (the amount which must be added to the \$76,400 to accommodate the 5% mandatory employee contribution). A large majority of the employees at each university are affected.

Earlier this year, the State University of Iowa (SUI) informed the Board Office that it had received tax advice from Deloitte and Touche (D&T), regarding a potential tax savings. D&T determined that it was unnecessary for SUI to pay FICA taxes on employees' mandatory contributions to retirement programs that SUI offered as an alternative to IPERS. SUI decided to pursue this potential saving. The

Board Office proposed that it should be pursued as an interinstitutional matter, with appropriate legal advice. After considerable consultation among the institutions and the Board Office, each Regent university contracted with D&T to do preliminary work in anticipation of securing permission from the Board to pursue both a refund of FICA tax payments for "open" tax years and for discontinuing future FICA tax payments. ("Open tax years" refers to the three years prior to the current tax year.)

On behalf of the Board, the Board Office sought legal advice from the Office of the Attorney General and was counseled that the decision to pursue this change in FICA tax treatment of retirement contributions needed approval of the Board.

The first step in the process of seeking the FICA tax refund is to secure a private letter ruling from the Internal Revenue Service (IRS) to determine if D&T's advice is correct. The IRS will be considering the re-characterization of the mandatory employee contribution to the Regent retirement system from an "employee payment" to an "employer payment" for FICA tax purposes only. Each institution will have to secure its own private letter ruling as each institution represents a separate paymaster.

If the IRS determines that the FICA tax need not be paid, then each institution intends prospectively to cease making FICA tax payments on the employees' mandatory contributions. If the IRS determines that the FICA tax must continue to be paid, the institutions will continue their present practice. If the decisions received by the Regent universities are inconsistent, this matter will be brought to the Board for further consultation.

If the IRS agrees with the D&T analysis, each university will have the task of contacting each employee who is affected by the request for a refund. An affected employee must give written permission for the university to seek a FICA tax refund on the employee's behalf. For an affected employee who does not give permission to the university to seek the refund, the FICA credit will remain just as if the university had not sought the refund of its contribution. An affected employee who does not grant the university authority to seek the refund on the employee's behalf could seek the refund as an individual. As the FICA tax is composed of equal contributions from the employer and the employee (6.75% each), the employer can seek the refund of the employer's portion without the employee seeking the refund of the employee portion.

Employees who authorize the university to seek refunds for them would receive the refunds from the university upon the university receipt of the refunds. The FICA tax paid by the university on this mandatory employee contribution would inure to the university. The universities may experience some claims by third parties, such as grant providers, to a portion of the refund it receives.

The process of seeking the private letter ruling and the refunds is expected to take about a year. The institutions will incur administrative costs in contacting

the affected employees, processing requests for refunds, issuing refunds, and professional services.

The universities have analyzed the economic impact on the retirement income of employees who would be affected by this decision. Their analysis indicates that an employee who saves the money not paid in FICA taxes, and who collects interest on the money at a modest rate of return, would not experience a loss in retirement income when those savings and interest are used to supplement retirement income.

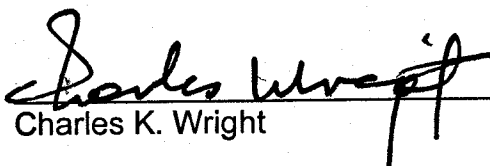
The Board Office review of the legal basis for the participation by Regent institutions in the Social Security program identified that the original decision for coverage was made by the state legislature. Relative to Social Security coverage, the legislature declared it to be the policy of the State "...to provide such protection to employees of the state and its political subdivisions on as broad a basis as is permitted under the Social Security Act, Title II." (Iowa Code §97C.1) The Board Office received counsel from the AG that this language would not preclude the Board from approving the universities' efforts to pursue the FICA payment refunds.

Each university indicates that it has engaged in some consultation with faculty and staff leaders relative to this proposal. If the Board approves the recommended actions, the universities will engage in broader, more formal discussions with faculty and staff prior to pursuing the private letter and refund.

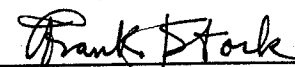
**Analysis:**

The Board has authority to permit the Regent universities to seek re-characterization of the employees' mandatory contribution to mandatory retirement programs which are an alternate to IPERS and to seek a refund of the FICA contributions made on these mandatory employee payments for all open tax years. The AG counsels that Board approval to seek the private letter ruling and refund is required; that they anticipate no negative impact to the State and its political subdivisions if the re-characterization and refund are sought; and that the law is not clear and direct in authorizing the proposed change. The Regent universities may realize savings on both a retrospective and prospective basis through this process.

The Board Office recommends authorizing the universities to pursue this re-characterization and refund process, with appropriate reports to the Board regarding progress on the matter.

  
Charles K. Wright

Approved: \_\_\_\_\_

  
Frank J. Stork