Social Security (FICA) and Medicare Taxes - FAQs

Employer and employee pension contributions paid to KRS are currently excluded when calculating required Social Security contributions. Why?

The method that the Commonwealth and most government employers in Kentucky have used to calculate their Social Security and Medicare tax liability for each payroll is by deducting the employer and employee pension contributions from the employee's gross wages to arrive at taxable FICA wages.

Why were Kentucky employers allowed to make this deduction?

Beginning in 1983, Congress and Kentucky passed legislation under 414(h) of the Unites States Internal Revenue Code that removed pension contributions from the employee's gross income until pension benefits were distributed by the pension system. This legislation exempted these payments, if the employer through withholdings paid the retirement deductions directly to the retirement system. Additionally, Kentucky had a private letter ruling from the Internal Revenue Service (IRS) that allowed this deduction.

*I heard that Kentucky employers will no longer be able to deduct pension contributions from the calculation of Social Security and Medicare tax liability. Is that true and wh*y?

Yes. During the period between 1983 and late 1999, various appeals court cases and rulings have been made regarding FICA and Medicare tax treatment of pension contributions. In addition, the IRS has continued to phase out private letter rulings. Kentucky is the last state to be addressed. The IRS required that Kentucky prepare a reasonable plan to change the treatment of the pension contributions to bring the state in compliance for calculating FICA and Medicare contributions. The IRS and the Kentucky Finance and Administration Cabinet have reached a settlement of this issue.

When will the change be effective?

Both employees and employers will impacted by this change beginning January 1, 2017. This settlement affects all governmental employees in the various retirement plans, including the executive, legislative, and judicial branches of state government, eight universities, the Kentucky Community and Technical College System, and 1,471 counties, city and local school districts. The state estimates that the additional annual cost will be approximately $5.7 million for state government agencies alone.

What is the impact of the change?

Every affected employee will see a reduction in net income due to the additional tax withholdings. For all employees who participate in Social Security, the additional contributions will result in increased Social Security benefits upon retirement. For income tax purposes, the employee retirement withholdings continue to be exempt.

Additional information regarding the Memorandum of Agreement between the Commonwealth of Kentucky and the IRS has been provided for the benefit of State and Local Government employers by the Finance and Administration Cabinet.

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To All State and Local Government Employers:

Under a Memorandum of Agreement between the Commonwealth of Kentucky and the Internal Revenue Service, effective on January 1, 2017, both the taxable FICA wages and taxable Medicare wages will be calculated on the employees' gross wages rather than allowing a deduction of the employee's pension contribution. This settlement affects all State and Local Governmental employers within the Commonwealth of Kentucky.

This means that beginning next year, each governmental employer and their respective employees will each have to pay the increased amount of FICA and/or Medicare taxes. But, the additional contributions in the FICA taxes will result in increased Social Security benefits upon retirement. For CY 2016, the current FICA tax rate is 6.2% and the current Medicare tax rate is 1.45%

Thus, effective January 1, 2017 all Kentucky State and Local Governmental employers must calculate the FICA taxes and/or Medicare taxes on their employee's gross salary rather than reducing the gross salary by the employee's pension contribution.

The deduction was originally allowed based upon the term "*picked up by the employer pursuant to a salary reduction agreement*". The federal courts have redefined this sentence to mean that the employer themselves must pay the amount of the pension contribution for the employee rather than deducting it from gross salary when they forward the withholdings to the pension system for it to be recognized as picked up.

It should be noted that the income tax withholding calculation for the State and Local Governmental employee will not change. Their pension contribution deduction will continue to be allowed for the calculation of their federal and state income taxes.

Please contact J. W. Bryan, State Social Security Administrator at jw.bryan@ky.gov or at (502) 565-6879 if you have any questions.

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