

November 7, 1995

Ms. Marie A. Sherry
Salem Township Office Manager
Salem Township
P.O. Box 75002
9600 Six Mile Road
Salem, Michigan 48175

Dear Marie:

As requested, we have prepared a draft of Amendment Number I to your Internal Revenue Code ("Code") Section 457 deferred compensation plan for review by you and your legal counsel. This amendment allows employees to waive FICA Tax coverage of their compensation. A condition of this waiver is that employees must agree to contribute at least 1.3% of their compensation (up to the Social Security Wage Base) to the 457 Plan. Pursuant to an employee waiver and 1.3% of compensation contribution, Salem Township will contribute 6.2% of such employee's FICA compensation to the 457 Plan.

Under the Amendment, an employee's election to waive FICA coverage is valid until revoked. An employee may revoke such an election between each December 1st and 31st, to be effective the immediately next January 1.

If you have any questions, please call me at (810) 827-0505.

Very truly yours,

EMPLOYEE BENEFITS CONSULTING GROUP



Mark T. Lachowicz

/cbl

cc: Mike Swartz

March 17, 1997

Mr. Michael J. Penn, CPA
Supervisor
Salem Township
9600 Six Mile Road
P.O. Box 75002
Salem Twp, MI 48175

RE: Salem Township - FICA Tax Waiver by Employees

Dear Mike:

In late January, you spoke with Mike Swartz regarding employees who have opted out of Social Security; specifically out of the Federal Insurance Contributions Act (FICA) tax coverage by contributing to an Internal Revenue Code (IRC) Section 457 plan. In particular, you asked Mike if individual employees could avoid FICA tax withholding by electing to participate in the Section 457 Plan maintained by Salem Township.

Background

Under prior law, service as an employee for a State or local government was not generally treated as employment for purposes of FICA, and wages of such an employee were not subject to FICA tax unless there was an agreement under Section 218 of the Social Security Act between the State and the Secretary of Health and Human Services covering the service.

Congress, through passage of the Omnibus Budget Reconciliation Act of 1990, added a section which ensured that employees of State and local government would be covered by either Social Security or a public retirement system.

Under IRC Section 3121(b)(7)(F), wages of an employee of a State or local government are generally subject to a tax under FICA after January 1, 1991, unless the employee is a member of a retirement system maintained by a State or local government entity that provides meaningful benefits.

Minimum Benefit Requirement

Certain minimum benefits need to be provided by a State or local government plan in order to be considered meaningful under the IRC and to allow wages to be exempt from FICA taxes. A defined contribution plan will generally satisfy the meaningful benefit requirement with respect to an employee if an allocation equal to at least 7.5% of the employee's compensation for the year is made to his or her account.

Furthermore, employee deferrals are taken into account to the same extent as benefits provided through employer contributions when calculating the 7.5% of compensation requirement.

Qualified Plan Not Necessary

Under the final regulations, generally, any retirement system that satisfies the minimum benefit requirement may be treated as a retirement system for purposes of 3121(b)(7)(F) of the IRC. The fact that a retirement system is not a qualified plan under the IRC is not relevant.

Retirement System Membership

An employee is treated as a member of a retirement system only if he or she actually participates in the system and actually has an accrued benefit or actually receives an allocation sufficient to satisfy the minimum benefit requirement. Allocations or accruals that are conditioned on the satisfaction of service, employee election, or other requirements are generally not taken into account until the employee actually satisfies those requirements.

The Salem Township Plan

Salem Township adopted the Michigan Township Association Master Deferred Compensation Plan (an IRC Section 457 Plan). In November, 1995, we drafted an amendment for review by the Township's attorney and, presumably, by the Township Board to be effective January 1, 1996, that allows employees, on an annual basis, to opt out of making FICA tax payments subject to several conditions:

- that each participant who opts out of the FICA tax will contribute at least 1.3% of their compensation (up to the Social Security taxable wage base in effect) to the 457 Plan;
- the election can only be made once annually in December of the year prior to the January 1 date that the election takes effect; and
- the election must remain in effect for a period of at least one year.

Additionally, the amendment reads that Salem Township will contribute 6.2% of their compensation (up to the Social Security taxable wage base in effect) to the 457 Plan for any participant who makes this election.

Conclusion

Salem Township has adopted a Section 457 plan and the Plan appears to provide the minimum benefit required under IRC 3121(b)(7)(F). That is, the Plan provides for employer and employee contributions equal or in excess of 7.5%. The fact that the Plan is a 457 plan and is not qualified under the IRC is not relevant to this discussion. An employee becomes a member under the terms of IRC 3121(b)(7)(F) once he or she makes an appropriate election. Since eligible employees can make an election to become members of a plan that provides a minimum level of benefits, those members need not have FICA tax withheld so long as they remain members of that plan and continue to contribute at least 1.3% of their compensation. Salem Township must also contribute a minimum of 6.2% of their compensation to the Plan.

Mr. Michael J. Penn
Salem Township

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The fact that all employees do not participate in the Section 457 Plan does not limit the ability of a limited number of employees to participate and opt-out of paying FICA taxes. The preamble to the proposed regulations gave the best explanation:

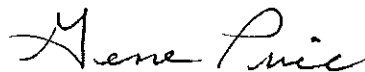
... the fact that a retirement system does not satisfy the requirements for a safe harbor formula does not mean that the services of all participants in the system are subject to FICA. Rather, failure to provide minimum retirement benefits to a participant in a retirement system affects only that participant and has no effect on any other participants as members of the retirement system.

As long as the Plan was amended on or prior to December 31, 1996, and participant election forms are submitted prior to January 1 of each year, participants in the Section 457 Plan who contribute at least 1.3% of their pay, with Salem Township contributing an additional 6.2% on their behalf, need not pay FICA taxes.

Please feel free to call me with any questions at (810) 827-0449.

Very truly yours,

EMPLOYEE BENEFITS CONSULTING GROUP



Gene M. Price

/mhe

Enclosures

cc: Mike Swartz

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PATRICIA S. JOHNSON

December 1, 1995

Ms. Marie A. Sherry
Salem Township Office Manager
P.O. Box 75002
9600 Six Mile Road
Salem, Michigan 48175

Dear Ms. Sherry:

I am in receipt of your letter dated November 9, 1995 and the accompanying documents from Plante & Moran. Chris Johnson has asked me to look over these materials and provide the legal opinion you requested.

I have reviewed the proposed Amendment No. 1 to the Michigan Township Association Master Deferral Compensation Plan, the Plan and Contract Joinder Agreement, the Disclaimer and the Master Deferral Compensation Plan. I have also reviewed various sections of the Internal Revenue Code and the applicable regulations. For purposes of this opinion letter, I am assuming that the materials you provided regarding the deferred compensation plan constitute all of the effective plan documents and that participation in and operation of the plan itself are in conformance with the terms and provisions of the plan documents. I am assuming, for purposes of this letter, that all the persons covered by this plan are employees of the State or of a local government.

It is my understanding that Salem Township is proposing to adopt Amendment No. 1 to the Master Deferral Compensation Plan for the purpose of allowing employees to opt out of the requirement to have Social Security and old age survivor's and disability insurance taxes withheld from their wages. As I understand it, the question you have posed to our firm is whether the proposed action is permissible under the current provisions of the Internal Revenue Code.

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The provision of the Internal Revenue Code directly on point is Title 26 U.S.C. §3121. Subsection (b)7 provides that services performed in the employment of a state or any political subdivision or instrumentality thereof shall not be considered employment for the purposes of the chapter of the Code dealing with employment taxes (Social Security and FICA). The regulations which have been passed under this section (in particular, 26 CFR §31.3121(b)(7)-2 provides a number of additional requirements before an employee can be exempted from the requirement to withhold Social Security and FICA taxes.

After July 1, 1991, an employee in the service of a state or political subdivision of a state will not be required to have Social Security and FICA withheld if the employee is a member of a retirement system that provides retirement benefits and has an accrued benefit or receives an allocation under a system that is comparable to the benefits he or she would receive under Social Security.

The foregoing statement contains a number of defined terms under the CFR. For example, an employee can be a member of a qualified plan only if they are currently entitled to non-forfeitable benefits. If there are any minimum service requirements or minimum age requirements, which prevent an employee from participating in a plan, then those persons cannot be considered members of a qualified plan. Likewise, any vesting requirements, or any requirements that prevent an employee from being immediately entitled to the full amount of benefits accrued, prevent such person from being a member of a qualified plan as long as the vesting or other requirements have not been met. None of those persons could opt out of the obligation to have Social Security or FICA withheld.

The same rules apply for part time employees. If a part time employee is not eligible to participate in a plan, or for any reason is not entitled to immediate vesting of all accrued benefits, then that person cannot opt out of the withholding requirements. For all employees, the regulations indicate that the tests are applied on a day by day basis to make certain that each person is a member of a qualified plan on each day of employment.

In order to be considered a retirement system, under the Code, it must provide retirement type benefits. The plan must provide pension, annuity a retirement or similar fund or system within the meaning of Section 218 of the Social Security Act. The fund must also provide a minimum level of benefits. The regulations state that the benefits provided by defined benefit plans must be comparable to the benefits provided under the old age portion of the Old Age Survivor and Disability Insurance Program of Social Security. The regulations further state that the test for whether

a program meets this requirement is made on an individual by individual basis. Therefore, the same retirement plan may be qualified with respect to one individual but not qualified with respect to another.

For defined contribution plans, such as the one operated by Salem Township, the requirement is that the defined contributions must be at least 7.5 percent of the employee's compensation. For this test, matching contributions by the employer may be taken into account. The definition of compensation used in determining the minimum contribution must generally be no less inclusive than the definition of the employee's base pay. So, for example, overtime pay, bonuses, or single sum of payments received on account of death or separation from service, or for bonified vacation, compensatory or sick pay, need not be included. Further, any compensation in excess of the contribution base for Social Security may also be disregarded.

Defined contribution plans also have a requirement of a reasonable interest rate. Under the regulations, the actual earnings on the trust fund must be measured after making deductions for all administrative expenses to determine whether the employee is receiving a reasonable return. As an example, the regulations state that a plan which provides a minimum interest rate of 100 percent of the applicable Federal rate for long term debt instruments constitutes a reasonable rate of interest.

The above requirements may be applied to the plan as proposed by Salem Township as follows:

The master deferral compensation plan appears to allow all employees to participate without minimum age or service requirements and without a vesting period. It includes in the definition of compensation all remuneration paid and does provide for retirement type benefits through an annuity.

Under Amendment No. 1, the plan is clearly a defined contribution plan and does provide for a minimum total contribution of 7.5 percent of an employee's compensation. Therefore, it is clear that most of the requirements set up by the regulations are met by the written documents themselves. It is important to recognize that a plan will be tested based on its actual performance and not necessarily on the written documents alone. In other words, it is necessary to have these provisions in the written documents, but it is also necessary to abide by the terms of the plan in practice. If employees are not allowed to sign up for the retirement plan, until they have a minimum service completed or are allowed up to sign up only during certain months of the year, then those persons will not be considered participants in your plan until those conditions are met. Until then, withholding for Social Security and FICA must be maintained.

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It is also important to note that a reasonable interest rate test cannot be met in advance. In other words, it is impossible to render an opinion today that the interest rate accruing on the retirement annuities will satisfy the regulation requirement for a reasonable rate for the next 20 years, or for any period of time into the future. It is possible for a plan to have a reasonable rate of return one year and an unreasonable rate the next followed by another reasonable rate of return the third year. The managers of the plan must take active interest in the types of investments the plan is investing in and the type of return being earned in each. The managers of the plan have an obligation to make active investment decisions so as to assure the beneficiaries that a reasonable rate of return continues to accrue.

Based on the foregoing, I can see nothing in the plan documents themselves that would lead to the conclusion that the plan does not comply with the Federal statutes and regulations applicable for employees of states or political subdivisions of states. I recommend that someone be assigned periodically to check to make certain that the plan's provisions are being implemented in accordance with its terms. I also recommend that the fund managers periodically review the investment vehicles and the rate of return being provided by them and make appropriate adjustments in the investment portfolio when necessary to provide a reasonable rate of return. I also recommend that an appropriate person be assigned on a periodic basis to check for changes in the statutes or regulations which would mandate additional or different requirements than those currently in place.

Please feel free to call me with any questions you may have regarding the above.

Very truly yours,



Edward M. Olson

EMO:jw