

# TEACHERS' RETIREMENT SYSTEM OF KENTUCKY

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*SERVING KENTUCKY TEACHERS SINCE 1940*

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## MEMORANDUM

**TO:** Agency Heads  
Payroll Officers

**FROM:** KTRS

**DATE:** April 27, 2016

**RE:** FICA and Medicare/Retirement Contributions

Last year, the Commonwealth of Kentucky initiated an outreach to employers concerning the settlement of a dispute with the Internal Revenue Service. Under the terms of this settlement, the Commonwealth agreed that in accordance with federal tax law, FICA and Medicare contributions would be applied to the employee retirement contributions to KTRS and KRS. In exchange, the IRS agreed that the application of FICA and Medicare contributions to employee retirement contributions would be postponed from January 1, 2016 to January 1, 2017, and further that no past tax liability would be assessed employers. This letter is to serve as a reminder to KTRS-participating employers of that agreement. Attached is a summary of the agreement and examples of the application of the FICA and Medicare contributions that were prepared by the Kentucky Finance Cabinet. For any questions, further clarification or assistance, please contact J.W. Bryan, State Social Security Administrator for the Commonwealth. He can be reached at (502) 564-6879 or [jwbryan@ky.gov](mailto:jwbryan@ky.gov).

Attachments

flp

## **Summary of IRS and Commonwealth of Kentucky Memorandum of Agreement on FICA and Medicare Contribution Compliance**

- In a December 3, 1986 letter the Commonwealth of Kentucky requested a ruling from the IRS to determine the taxable base on which Kentucky then calculated the FICA tax each employee paid into Social Security (the calculation was based on 1983 Kentucky statutes).
- The Commonwealth indicated that since a percentage is automatically deducted from employees' wages, which the state then contributes in aggregate to the different retirement funds on behalf of the employees, this amount should be exempt from wages for FICA calculation purposes. This primarily impacts employees of these retirement systems<sup>i</sup>:
  - Kentucky Employee Retirement System (KERS)
  - County Employee Retirement System (CERS)
  - State Police Retirement System (SPRS)
  - Kentucky Teacher Retirement System (KTRS)
  - Legislators' Retirement System
  - Judicial Retirement System
- The IRS issued a private letter ruling dated February 2, 1987 exempting the pension contribution amount from wages for FICA purposes for employees of the afore mentioned retirement plans. Therefore, since 1987 the Commonwealth has based FICA taxes for employees on 95% instead of 100% of wages (on average, employees contribute 5% to retirement<sup>ii</sup>). That is, employees paid less FICA taxes over the years because the calculation was based on 95% of their wages.
- Based on federal statute changes and the Tenth Circuit of United States Court of Appeals ruling in Public Employees Retirement Board v. Shalala, in May 2014, the IRS notified Finance and Personnel Cabinet representatives that the retirement contribution amount is indeed to be included in FICA taxable wages, requiring that all wages be taxable (except for cafeteria plan withholdings).
- The IRS required that Kentucky prepare a reasonable plan to change the treatment of the pension contributions to bring the state into compliance for calculating FICA and Medicare contributions prior to January 1, 2016.
- Through a series of negotiations, the Commonwealth resolved this dispute by first assuring that no past liability would be owed by government agencies and second, that the new calculation would be effective January 1, 2017 to give agencies adequate time to plan for budgeting purposes, make changes to payroll systems, and communicate effectively with all impacted employers and employees.

- Effective January 1, 2017, the only allowable deduction from gross wages to calculate the tax will be cafeteria plan withholdings (i.e. health insurance, flex spending accounts).
- The settlement affects all governmental employers in the various retirement plans, including the Executive, Legislative and Judicial Branches of state government, 8 universities, KCTCS, and 1,471 county, city and local school districts. The state estimates that the additional annual cost will be approximately \$5.7 million for state government agencies alone.
- Both employers and employees will have to pay the increased amount. An example of the increased cost is attached. Note that for employees who participate in Social Security, the additional contributions will positively impact Social Security benefits upon retirement.

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<sup>i</sup> Governmental employers can opt to sign a Section 218 agreement that means employees will be covered by Social Security. Section 218 is from the 1951 federal legislation establishing Social Security.

<sup>ii</sup> Employee contribution percentages vary based on system, classification, tier and date-of-hire. For example KERS: Tier 1= 5%, Tiers 2 & 3=6%. KERS Hazardous: Tier 1=8%, Tiers 2 & 3=9%. KTRS: 12.855% + Medicare rate.

**IRS MEMORANDUM OF AGREEMENT**  
**EXAMPLE CALCULATION FOR COST TO EMPLOYEES and EMPLOYERS PER PAY PERIOD**  
 Beginning January 1, 2017

Rev. 8-11-2015

**ASSUMPTIONS:**

Average Annual Salary = \$40,500

FICA = 6.2%

Monthly Salary = \$3,375

\*Medicare = 1.45%

Semi-monthly = \$1,687.50

	KY RET SYSTEM KERS/CERS		KY RET SYSTEM-HAZARDOUS KERS/CERS/KSP		JUDICIAL & LEGISLATIVE RET SYSTEM		OTHER RETIREMENT SYSTEMS TIAA-CREF KTRS UNIVERSITIES Regional Univ		MEDICARE ONLY TEACHERS NO SOCIAL SEC COVG	
	Tier 1=5%	Tiers 2 & 3 = 6%	Tier 1=8%	Tiers 2 & 3 = 9%	Tier 1=5%	Tier 2=6%	5.00%	8.185%	12.855%	5.0%
Pension Contribution Percentage^										
<b><u>CURRENT CALCULATION:</u></b>										
Semi-monthly Gross Pay	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50
Less Retirement Contribution	84.38	101.25	135.00	151.88	84.38	101.25	84.38	138.12	216.93	84.38
Base Wages for FICA	1,603.13	1,586.25	1,552.50	1,535.63	1,603.13	1,586.25	1,603.13	1,549.38	1,470.57	1,603.13
FICA tax	99.39	98.35	96.26	95.21	99.39	98.35	99.39	96.06		
Medicare tax	23.25	23.00	22.51	22.27	23.25	23.00	23.25	22.47	21.32	23.25
<b>Total FICA &amp; Medicaid per period</b>	<b>122.64</b>	<b>121.35</b>	<b>118.77</b>	<b>117.48</b>	<b>122.64</b>	<b>121.35</b>	<b>122.64</b>	<b>118.53</b>	<b>21.32</b>	<b>23.25</b>
<b><u>NEW CALCULATION:</u></b>										
Semi-monthly Gross Pay = Base wages for FICA	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50
FICA tax	104.63	104.63	104.63	104.63	104.63	104.63	104.63	104.63		
Medicare tax	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47
<b>Total FICA &amp; Medicaid per pay period</b>	<b>129.09</b>	<b>129.09</b>	<b>129.09</b>	<b>129.09</b>	<b>129.09</b>	<b>129.09</b>	<b>129.09</b>	<b>129.09</b>	<b>24.47</b>	<b>24.47</b>
<b>Total withholding increase Per Pay Period (agency &amp; employee)</b>	<b>6.45</b>	<b>7.75</b>	<b>10.33</b>	<b>11.62</b>	<b>6.45</b>	<b>7.75</b>	<b>6.45</b>	<b>10.57</b>	<b>3.15</b>	<b>1.22</b>

\* Everyone hired after 1986 is federally mandated to pay Medicare.

^ Employee contribution percentages vary based on system, classification, tier and date-of-hire.