Article from

In The Public Interest

January 2019
Issue 18

Mandatory Social Security Coverage of State and Local Government Employees

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In 2019, nearly all employees of private-sector corporations in the United States, as well as U.S. nationals working for U.S. employers or certain foreign subsidiaries of U.S. employers, are **mandatorily** covered by the U.S. Social Security program. Almost none of these employees (or their employers) has any choice in the matter. The law requires that they participate in Social Security and pay the mandatory payroll taxes. (Eligible retirees are not required to apply for benefits, but nearly all do eventually!) Mandatory Social Security coverage is also imposed on nearly all self-employed individuals who file U.S. income-tax returns and have net earnings from self-employment exceeding a *de minimis* amount. Federal Government employees hired since Jan. 1, 1984, and a small number of very high-level employees (e.g., members of Congress and Federal judges) hired before that date are mandatorily covered, as well.

Employees of state and local governments are different and follow their own special rules. Because of constitutional concerns regarding the Federal Government's ability to tax states (as employers, in the case of Social Security coverage), employees of state and local governments can be covered by Social Security in only two ways under present law:

1. Mandatorily for employees working in positions that are **not** covered by an employer-sponsored retirement plan deemed to be "comparable" to Social Security, or

2. voluntarily, for employees working in positions that are covered by a "comparable" employer-sponsored retirement plan.

In the first situation, mandatory coverage of state and local government employees not covered by a retirement plan comparable to Social Security was enacted into law by section 11332 of the Omnibus Budget Reconciliation Act of 1990 (Public Law 101-508), with an effective date of July 2, 1991. The relevant subsection of the Internal Revenue Code is 3121(b)(7)(F). Notwithstanding constitutional limitations on the Federal Government taxing states (an interpretation that flows from the 10th Amendment), the mandatory imposition of Social Security taxes under these circumstances, affecting 2.4 million individuals at the time of enactment, has never been tested in the Supreme Court. Closely related cases suggest strongly that it would be approved, based on the principle that the interests of the affected employees in having some reasonable retirement benefit should be given more weight than the interests of the states employing them. Note that mandatory Social Security coverage of **all** state and local government employees is proposed rather frequently in Congress and elsewhere and would undoubtedly be challenged and debated on these same grounds. Mandatory Medicare coverage of newly hired state and local government employees took effect on April 1, 1986. It's hard to believe that Medicare coverage of these employees would be constitutional but Social Security coverage would not be.

The clearest situation under the law involves employees of state and local governments in positions that are not covered by **any** employer-sponsored retirement plan. These employees are obviously subject to mandatory Social Security coverage (and have been since July 2, 1991), because a nonexistent retirement plan cannot be comparable in any sense to Social Security. Employees in positions not covered by any retirement plan are

called absolute coverage groups. Social Security taxes must be withheld from their wages and salaries (up to the maximum taxable amount each year) and matched by their governmental employers.

When an employer-sponsored retirement plan does exist, the plan must be tested to determine whether it is comparable to Social Security. Plans are deemed to be comparable if they pass one of two tests, which are explained in IRS Publication 963 (*http://www.irs.gov/pub/irs-pdf/p963.pdf*). One test, the simpler one by far, is used to assess defined-contribution plans; the other applies to defined-benefit plans.

Defined-contribution plans satisfy the comparability test under IRS Regulation 31.3121(b)(7)-2(e)(2)(iii) if they provide for an allocation to each employee's account of an amount equal to or exceeding 7.5 percent of the employee's compensation during any time period under consideration. Contributions from both the employer and the employee are combined for purposes of meeting the 7.5-percent threshold. Plans with only employee contributions may satisfy the minimum contribution requirement, provided that the employee contributions are at least 7.5 percent of compensation. The 7.5-percent contribution cannot include any investment earnings on the account.

The retirement plan's definition of "compensation" that is used to determine whether the contribution is sufficient to satisfy the Social Security comparability test must include at least the employee's base pay, provided that the definition of "base pay" is reasonable. The plan may disregard for purposes of defining compensation overtime pay, bonuses, amounts received due to death or separation from service, amounts received under a bona fide vacation, compensatory time or sick pay plan, and severance pay.

Interestingly, the comparability test's requirement that contributions equal or exceed 7.5 percent of compensation is applied to each employee individually, one pay period at a time. Thus, a group of state and local government employees covered by a defined-contribution plan may include some employees who are always mandatorily covered by Social Security, some who are mandatorily covered by Social Security at certain times but not at other times, and some who are never mandatorily covered by Social Security. Of course, employees who are not mandatorily covered by Social Security may be covered under a voluntary-coverage agreement.

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Defined-benefit plans **generally** meet the requirement of providing a benefit comparable to Social Security if the benefit under the retirement plan is at least 1.5 percent of average compensation during an employee's last three years of employment, multiplied by the employee's number of years of service. Formulas in Revenue Procedure 91-40 and the IRS regulation referenced above explain in grueling detail how to satisfy this requirement. Those calculations are beyond the scope of this brief article.

As noted above, governmental employees who are not covered by an employer-sponsored retirement plan or who are covered by a plan that does not meet either of the Social Security comparability tests are mandatorily covered by Social Security. However, if such employees become covered at some point by an employer-sponsored retirement plan that is comparable to Social Security, then mandatory coverage ceases. Depending on the governmental employer involved, they may then become covered under a voluntary-coverage agreement or remain non-covered by Social Security.

The next article in this series will discuss voluntary-coverage agreements under section 218 of the Social Security Act. ■

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