13. Integrating Pension Plans with Social Security

Introduction

Social Security taxes and benefits are a higher percentage of total compensation for lower paid employees than for higher paid employees. To allow employers to balance the benefit tilt toward lower paid employees inherent in the Social Security system, a system of pension integration rules evolved, culminating in 1971 with the release of Revenue Ruling 71-446, which was in effect until the enactment of the Tax Reform Act of 1986 (TRA '86). Integration allows the employer's pension to be combined with Social Security to result in an overall retirement scheme. While pre-TRA '86 integration rules no longer apply, it is useful to review their application as a basis for understanding the new rules.

Integration works differently for defined benefit and defined contribution plans. Under defined contribution plans, prior to TRA '86 an employer was allowed to make a total contribution (i.e., to the pension plan plus Social Security, exclusive of Medicare) that resulted in a constant percentage of compensation for all employees.

Integration rules for defined benefit pension plans represented the same logic, although the employer's contributions to Social Security first had to be translated into benefits for the employee. Recognizing that Social Security (exclusive of Medicare) represents more than just retirement benefits for the employee (e.g., spousal benefits as well as death and disability benefits), a value of 162 percent of the employee's retirement benefit was placed on the package of benefits received. Acknowledging the argument that the employer pays 50 percent of the payroll tax assessed for these benefits, pension integration rules for defined benefit pension plans were based on the concept that employers should be able to receive credit for approximately one-half of 162 percent (or 81 percent) of the primary retirement benefit for the employee.

In actual practice, this figure was increased up to 83.3 percent. Employers with defined benefit plans utilizing the offset approach to integrating their pension plans were allowed to subtract up to 83.3 percent of the initial primary Social Security benefit from the gross pension benefit. A very large percentage of the employers adopting this approach concluded that it would be too difficult to communicate the rationale for taking credit for more than one-half of the Social Security retirement benefit actually received by the employee and chose to offset only 50 percent of the employee's primary Social Security benefit. Plans were allowed to offset by 83.3 percent of the entire Social Security benefit, even when the employee earned most of the benefit working for other employers.

Many employers chose to accomplish the same objective through an excess approach in which an employee would receive less benefit accrual (or none at all) for compensation below a threshold known as an integration level. The pre-TRA '86 mechanics of this approach were relatively complex and are no longer relevant for current pension plans. But it is important to recognize that, although the integrated pension plans of the past were actuarially equivalent to the other approaches, much of the controversy surrounding those plans resulted from the use of pure excess pension plans in which employees with compensation below the integration level could put in an entire career with an employer and receive no pension benefit.

One of the primary objectives of TRA '86 was to narrow the permitted integration spread and eliminate plans based solely on pay in excess of Social Security wages. This was accomplished (in principle) through the expansion of Internal Revenue Code (IRC) sec. 401(l), which essentially provides an exception for integrated plans to the general nondiscrimination rules that prohibit plans from providing highly compensated employees
benefits that are greater, as a percentage of pay, than benefits provided to nonhighly
compensated employees. Although sec. 401(l) was the only specific exception available for
integrated plans, regulations on general nondiscrimination (IRC sec. 401(a)(4)) provide
additional rules that apply to integrated plans. (For further discussion of these rules, see
chapter 12 on nondiscrimination requirements for pension plans.)

Integration after the Tax Reform Act of 1986

IRC sec. 401(l) and its related regulations explicitly allow for three different approaches
to integration: defined benefit offset, defined benefit excess, and defined contribution.
Regardless of which of these approaches is chosen, the employer must take into account
three key elements in the design of an integrated plan:

• **Integration Level**—This is a threshold based on compensation that determines which
  participants will receive benefit accruals or contributions in excess of the basic rate
  and the proportion of their compensation that will benefit from the higher rate.

• **Maximum Offset or Spread**—This refers to the so-called “permitted disparity” between
  benefit accruals (in a defined benefit plan) or contributions (in a defined contribution
  plan). It places a limit on the difference that can exist between the accruals or
  contributions of employees who earn more than the integration level and those who
  earn less.

• **Two-for-One**—This is a constraint not found in pre-TRA ’86 legislation that implicitly
  prevents employers from integrating a plan to prevent lower paid employees from
  receiving any pension benefits or contributions. For defined benefit excess and defined
  contribution plans, this is similar in concept to one of the nondiscrimination tests for
  401(k) arrangements. (For further discussion of nondiscrimination tests, see chapter 8
  on 401(k) cash or deferred arrangements.) The two-for-one rule limits the maximum
  benefit or contribution for employees earning more than the integration level to twice
  the value (expressed as a percentage of compensation) below the integration level.
  Thus, if compensation below the integration level receives no benefit or contribution,
  no additional amount may be provided to compensation in excess of the threshold. For
  defined benefit offset plans, this rule is implemented (albeit in a complex manner) by
  limiting the dollar amount of the offset to one-half of the gross dollar benefit (before
  applying the offset).

Defined Contribution Plans

In general, an integrated defined contribution pension plan must be designed so that the
maximum spread between the two contribution levels is 5.7 percent and the contribution
rate above the integration level is no more than twice the rate below. For example, a defined
contribution plan providing 5 percent of compensation for amounts below the integration
level may not provide more than 10 percent for compensation in excess of the integration
level. Anything more than 10 percent would violate the two-for-one rule. However, if a
defined contribution plan provided a 7 percent contribution for compensation less than the
integration level for the year, the maximum contribution for compensation greater than the
integration level would be 12.7 percent. Anything greater than 12.7 percent would violate
the 5.7 percent constraint. The integration level typically used for defined contribution
plans is the Social Security wage base at the beginning of the current year.

An employer with a defined contribution plan may integrate the plan at a lower dollar
threshold. In such cases, there are two alternatives. Under the first, an employer may
choose an integration level less than or equal to 20 percent of the wage base of the current
year or $10,000, whichever is greater. In 1995, this option would result in a maximum uniform dollar amount for all participants of $12,240 (because 20 percent of $61,200 (the 1995 Social Security wage base) is $12,240, which exceeds $10,000). This option allows an employer to adopt an integration level lower than the wage base, but it also results in a threshold so low that the vast majority of participants will receive the higher contribution rate on at least a portion of their compensation.

A second alternative allows the employer to designate an integration level at a point between the full wage base and the amount determined under the first alternative. Realizing that using such an interim integration level increases the possibility of discrimination, IRS requires that the 5.7 percent constraint mentioned above must be reduced if the second alternative is used.4

**Defined Benefit Plans**

An integrated defined benefit plan must be based on average annual compensation, defined as an average of at least three consecutive years’ pay,5 compared with nonintegrated plans, which may use different formulas. The employer is allowed to choose the averaging period, but in an integrated plan the employer must use the years of an employee’s career that produce the highest average. (Due to their systematic differences in benefit accruals, exceptions are granted for career average or unit benefit plans. These plans may determine each year’s benefit using that year’s compensation.) (For a discussion of pension plan formulas, see chapter 4 on pension plans.)

**Integration Level**—An important concept for determining the integration level used in defined benefit plans is the participant’s covered compensation, defined as the average of the Social Security wage base for the 35 years up to and including the employee’s Social Security retirement year. Although the Social Security normal retirement age is scheduled to increase in the future under a very detailed set of rules, for purposes of integration, the retirement age is determined as follows:6

Covered compensation amounts for 1995 are provided for selected years of birth in table 13.2. However, the actual integration level chosen for the plan must not exceed the wage base at the beginning of the year and may be either the covered compensation for each participant or one of four alternatives.

**Excess Defined Benefit Plans**—Under an excess defined benefit plan, the percentage of compensation at which benefits accrue with respect to compensation above the integration level may not be greater than 0.75 percent of compensation per year of service.7 Moreover, this rate may not be more than twice the rate applied to compensation below the integration level.

**Offset Defined Benefit Plans**8—The limits for an offset plan are based on final average compensation, defined as the average of a participant’s annual compensation (excluding pay in any year above that year’s wage base) for the three-consecutive-year period ending with the current plan year. (If a participant has worked fewer than three years, his or her compensation is to be averaged over the entire period of service.) The maximum offset is equal to 0.75 percent of final average compensation (up to the integration level) per year of service. As in the other two types of integration, the two-for-one rule is in effect and in this case specifies that the offset cannot be more than one-half the benefit that should be provided, prior to the application of the offset, with respect to the participant’s average annual compensation not in excess of final average compensation (up to the integration level).
Career Cap—Both the excess and offset approaches for defined benefit (but not defined contribution) plans are subject to an additional constraint for long-term employees. The annual permitted differential of 0.75 percent is capped at 35 years of service with the current employer.

Adjustments—The 0.75 percent factor mentioned above must be adjusted in the event of early retirement or integration levels that are outside specified boundaries. If benefits are paid before Social Security normal retirement age, the maximum 0.75 percent must be reduced in accordance with table 13.2 even if benefits under the pension plan are actuarially reduced for early retirement. Adjustments to the 0.75 percent factor may also be required for different integration levels.

1 As explained in chapter 2, Social Security benefits receive automatic cost-of-living adjustments. Employers adopting this approach were not allowed to increase the offset as the retiree’s Social Security benefit increased.

2 The terms highly compensated employee and nonhighly compensated employee have specific statutory definitions. (For further discussion of these terms, see chapter 4 on pension plans.)

3 This figure may increase in the future with increases in the Old Age portion of the employer’s Social Security tax rate.

4 A proportional reduction is also required in the old age portion of the Social Security contribution rate.

5 If a participant has worked less than three years, compensation must be averaged over the entire period of service.

6 The Small Business Job Protection Act of 1996 allows plans to use the official Social Security retirement age for discrimination testing.

7 Only years of service during which benefits accrue may be counted.

8 Prior to the Tax Reform Act of 1986, the allowable offset for an integrated defined benefit plan was based on the participant’s Social Security benefit, but thereafter it is based on his or her compensation and service.

Table 13.1

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<th>Year of Birth</th>
<th>Social Security Retirement Age</th>
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<tr>
<td>1937 and Earlier</td>
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<td>1938 through 1954</td>
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<tr>
<td>1955 and Later</td>
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Table 13.2

1996 Covered Compensation for Integration Purposes, Selected Years
1996 Wage Base = $62,700

<table>
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<th>Year of Birth</th>
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<tbody>
<tr>
<td>1930</td>
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<tr>
<td>1940</td>
<td>43,677</td>
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<td>1950</td>
<td>56,589</td>
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<tr>
<td>1960</td>
<td>62,451</td>
</tr>
<tr>
<td>1963 or Later</td>
<td>62,700</td>
</tr>
</tbody>
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