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IRS LIMITATIONS ON INTEGRATION OF DEFINED BENEFIT PENSION PLANS WITH UNITED STATES SOCIAL SECURITY

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ABSTRACT

The statutory and regulatory rationale for the Internal Revenue Service position is presented. It is expected that an understanding of the reasons behind the details will make the latter more manageable.

I. INTRODUCTION

The retirement income objective (expected benefit payout) is an important consideration in the design of a pension plan. The elements of this objective should reflect the various sources of income available to the typical plan participant. Retirement benefits provided under the United States social security system are a principal source.

The plan design can reflect the level of social security benefits indirectly, or benefits can be "integrated" with social security. It is this latter approach, in which a benefit formula explicitly recognizes social security benefits, with which we will be concerned in the following. In order for a private pension plan to receive favorable tax treatment, it must satisfy the qualification requirements promulgated under Internal Revenue Code section 401(a). One of these requirements (the prohibited discrimination requirement) is that benefits or contributions may not discriminate in favor of officers, shareholders, or highly compensated individuals. For this purpose, benefits include those provided under social security by employer contributions.

Social security benefits are relatively higher for low-paid than for high-paid individuals. Thus, integration can be viewed as the process of devising a benefit formula that favors high-paid individuals, to ameliorate the reverse effect of social security while not running afoul of the nondiscrimination requirements of the Internal Revenue Service (IRS).

* NOTE.—The views expressed herein are the author's own and do not necessarily represent those of any government agency.

The IRS has promulgated rules to provide guidance for ensuring compliance with the prohibited discrimination requirement in the design of integrated plans. Revenue Ruling 71-446 is the current principal guide. If prohibited discrimination, as defined above, is a possibility, then the requirements of this ruling must be satisfied. The details of the ruling are involved. They reflect the means by which integration can be effected as well as the variability in plan design, which can affect the value of plan benefits.

The purpose of this paper is to make a conceptual presentation of the legal integration requirements and the interrelationship of such requirements. With a view of the underlying rationale, the maze of detail may be easier to digest. This discussion is not intended as a substitute for the specific detailed provisions of revenue rulings, the Income Tax Regulations, or the Internal Revenue Code that are referenced.

II. HISTORY

Favorable federal tax treatment for employer contributions made to pension plans dates back to the 1920s. The Revenue Act of 1921 allowed deductions for contributions made to profit-sharing or stock bonus plans. Similar treatment was extended to pension trusts by the Revenue Act of 1926. However, it was not until the Revenue Act of 1942 was passed that discrimination became a potential issue in the deductibility of employer contributions.

This amendment to the Internal Revenue Code brought about significant changes in pension plan design. Favorable tax treatment was conditioned on the requirement that benefits or contributions be provided to employees in a nondiscriminatory manner and amount. These provisions did recognize, however, that retirement benefits were already being provided, in part, through employer social security contributions. Accordingly, the discrimination provisions required that plan benefits plus employer-provided social security benefits not result in prohibited discrimination.

Since 1942 this basic requirement has changed very little. That is not true, however, of the specific rules implementing the requirement. In order to treat employers and employees in a mutually equitable manner, the details involved in assigning credit to employers for a portion of social security benefits depends on the prevailing level of such benefits. Thus, Mimeograph 6641, published in 1951, changed the rules enunciated in Mimeograph 5539, which was published in 1943. An important reason for the change was the change in benefit structure occasioned by the 1950 amendments to the Social Security Act.

In 1969, Revenue Ruling 69-4 restated the requirements of Mimeograph

6641 and incorporated intervening modifications, in light of changes made in social security benefits.[1] Revenue Ruling 69-4 precipitated a fair amount of public reaction, and so, upon reconsideration, Revenue Ruling 71-446 was issued. This latter ruling continues to be the primary basis for determining whether a plan, by design, is nondiscriminatory even though it provides relatively higher benefits for higher-paid employees. Put another way, the ruling is used to determine whether a plan is properly integrated for tax qualification purposes.

III. RATIONALE

When Does the Discrimination Standard Apply?

As mentioned above, the integration requirements are subordinate to the prohibited discrimination requirements of section 401(a)(4) of the Code. One immediate consequence is that if section 401(a) does *not* apply, then neither do the integration requirements.

Section 401(a)(4) indicates that, as a condition to tax qualification, a plan must provide that

> the contributions or the benefits provided under the plan do not discriminate in favor of employees who are—
> (A) officers,
> (B) shareholders, or
> (C) highly compensated.

The section goes on to indicate that nonresident aliens and union employees who are not covered by the plan are excluded from consideration when the standard is applied.

Examples of plans that would not be subject to the prohibited discrimination requirements, and, therefore, would not be subject to the integration requirements, include those that cover *only* (1) employees who are not officers, shareholders, or highly compensated; (2) nonresident aliens; and (3) equal shareholders who earn the same compensation.

A plan meeting one of these three criteria could provide a benefit formula of 50 percent of high three-year average pay for employees born in even-numbered years and 70 percent for all others. Although there are employee-relations reasons that militate against such an arrangement, it is not a type of discrimination that violates the prohibited discrimination requirement. These examples are intended to illustrate the principle of application of the discrimination standard. However, as a practical matter, virtually all plans are subject to this requirement.

[1] For example, see Revenue Rulings 13, 56-692, 61-75, and 67-10.

How Does the Discrimination Standard Apply?

In determining whether a plan satisfies the prohibited discrimination standard, "retirement benefit(s) created under State or Federal law" can be included with plan benefits.[2] This is the regulatory basis for assigning retirement benefit credit to employers for the portion of social security benefits *deemed* attributable to their contributions.

Once plan benefits and employer-provided social security benefits are aggregated, the test is the following: *Benefits or contributions cannot increase as a percentage of compensation as compensation increases.*[3]

As discussed below, this test can be satisfied on a flat- or unit-benefit basis. Total plan benefits, independent of service are analyzed in the former, while the latter involves the annual rate of benefit accrual.

What Is the Value of Employer-provided Social Security Benefits?

Section 1.401-3(e)(2) of the Regulations sets out the rationale for the development of this amount in detail. The value, assigned by regulation, of employer-provided social security benefits is 37½ percent of the maximum average covered wages on which benefits are based. In arriving at this formulation, a specific set of plan design features was used.[4] These include the following:

1. Compensation is averaged over a period that is not less than five years.
2. There are no preretirement death benefits.
3. A straight life annuity payable at normal retirement age 65 is the normal form of payment.
4. The minimum service at age 65 required to accrue the full 37½ percent is fifteen years. Shorter total service requires a pro rata reduction in the maximum (i.e., 2½ percent per year).
5. Benefits at termination of employment before age 65 accrue pro rata over total service at age 65 (i.e., fractional rule).
6. No subsidized ancillary or early retirement benefits are provided.

Having established the employer's social security credit, we can now tie this back to the prohibited discrimination standard. A plan that conforms with the six standard features can provide for individuals with fifteen or more years of service a benefit of 37½ percent of average compensation in excess of average FICA wages (called covered compen-

[2] See Income Tax Regulations, secs. 1.401-3(e) and 1.401-4(b).

[3] See ibid., sec. 1.401-4(a)(2)(i).

[4] See Revenue Ruling 71-446, secs. 3, 4, and 5.

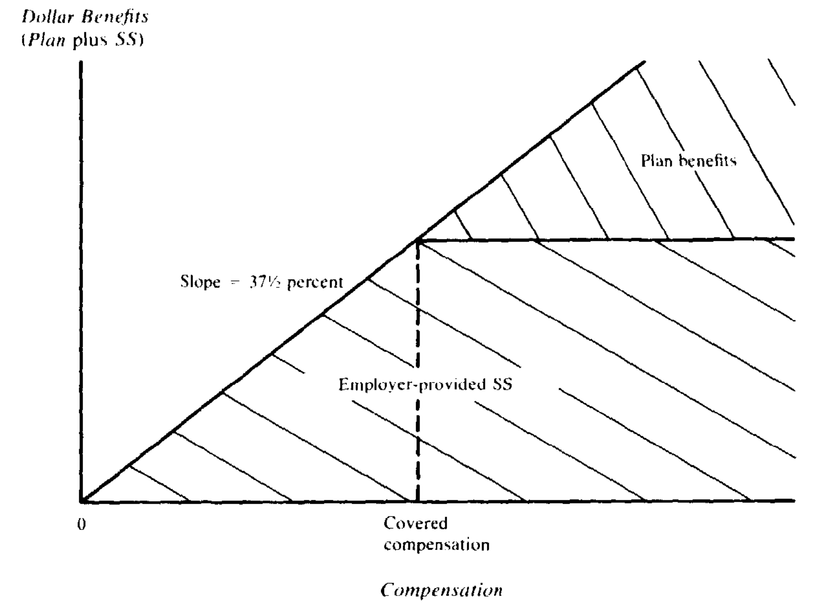

FIG. 1.—Schematic representation of a properly integrated plan

sation)[5] and satisfy the prohibited discrimination standard. Figure 1 is a schematic representation. This can also be stated as requiring that the ratio

$$\frac{\text{Plan benefits} + \text{employer-provided social security}}{\text{Compensation}}$$

cannot increase as compensation increases.

If all plans were designed in conformance with the above-listed standard criteria, further elaboration would be unnecessary. However, retirement programs are designed to meet a wide range of needs of different plan sponsors. Retirement ages earlier than 65, subsidized early retirement benefits, and various ancillary benefits are all common features. Recognizing this, as well as differences in basic design (e.g., flat- versus unit-benefit), the Regulations authorize the accommodation of such variations based on the principles enunciated in the Regulations and summarized

[5] See ibid., sec. 2.03.

above.[6] Revenue Ruling 71-446 is the primary publication that is intended to accomplish this objective.

Ancillary Benefits: What Is the Effect on the Integration Limits?

In Section IV we will go into the details of how ancillary benefits affect the integration limits. For now, let us look at the reasons.

In considering the various forms that the credit assigned to employer-provided social security benefits may take, the following analogy might be helpful. On one side of a balance scale is the value these benefits are deemed to have; this is an absolute and can be represented by a single weight. On the other side is the maximum "integrated" plan benefit that conforms with the standard criteria, is equal to 37½ percent of pay in excess of covered compensation, and is represented by a collection of weights that in total equal the single weight.

Deviating from the standard criteria for the integrated benefit could increase the value of that benefit, which would tip the scale in its favor, and this in turn would cause total benefits to be relatively higher for higher-paid individuals. For example, adding a preretirement death benefit of 100 times the anticipated retirement benefit would constitute adding another weight to the integrated benefit side of our scale. The graphic representation is shown in Figure 2.

The imputed value of employer-provided social security benefits cannot be increased, but we can restore equipoise in our example by reducing the amount of the maximum integrated benefit (i.e., reducing the 37½ percent excess benefit) until there is a balance. One of the purposes of Revenue Ruling 71-446 is to provide the mechanics for restoring balance by reducing the otherwise applicable limits when integrated benefits are part of a plan that has design features more valuable than those features on which the value of employer-provided social security benefits was based.

Nonintegrated benefits do not affect the integration limits because they do not affect the value of the integrated benefits. Nonintegrated benefits, by definition, are not relatively greater for higher-paid individuals and, therefore, are nondiscriminatory on the basis of pay. Examples of non-integrated benefits include the following:

1. Death benefits: flat dollar (e.g., $1,000) or level percentage of pay (e.g., two times pay).
2. Retirement benefits: flat dollar (e.g., $200) or level percentage of pay (e.g., 25 percent of average compensation) payable at a specific age (e.g., age 62).

[6] See Income Tax Regulations, sec. 1.401-3(e)(2)(v).

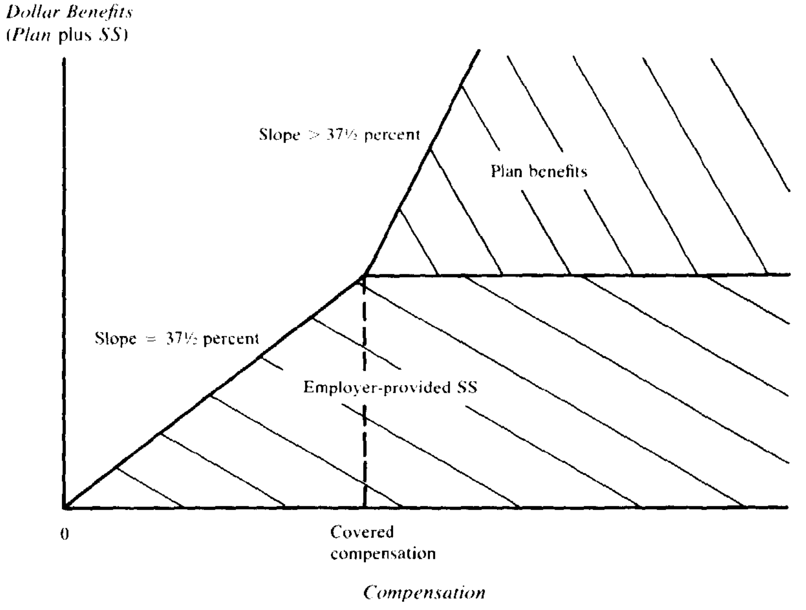

FIG. 2.—Schematic representation of integrated plan after adding preretirement death benefit.

Consider a plan that provides a retirement benefit of 20 percent of high five-year average pay up to "covered compensation" and 57½ percent of average pay in excess of such amount, and a lump-sum preretirement death benefit of $5,000. The retirement benefit can be separated into a nonintegrated portion—20 percent of average pay—and an integrated portion—37½ percent of excess pay. In ascertaining whether this plan is properly integrated (i.e., is nondiscriminatory by design), we need be concerned only with the integrated portion. The 20 percent of pay portion and the lump-sum death benefit are nondiscriminatory by definition.

IV. DETAILS

So far, the maximum integration limits have been presented in the context of a flat-benefit excess plan in which benefits are based on pay in excess of some amount. There are other forms of benefit formulas. Revenue Ruling 71-446 provides equivalencies for the value of employer-provided social security, and hence the maximum integration limits for unit-benefit excess plans and offset plans. In the latter, an otherwise nonintegrated plan formula includes a reduction of a stated percentage of a participant's social security primary insurance amount. It also gives the general rules and associated "safe harbors" for reductions in the otherwise applicable maximum limits when a plan provides integrated ancillary benefits.

Excess Plans[7]

Benefits under excess plans are based on pay in excess of a dollar amount referred to in Revenue Ruling 71-446 as the integration level. For both unit-benefit and flat-benefit plans that base benefits on high five-year average earnings, the integration level or bendpoint[8] is defined as the covered compensation[9] for a covered participant or a stated dollar amount that does not exceed the covered compensation for anyone who is or could be a participant, the so-called worst-case test. Prior to the 1977 social security amendments, covered compensation increased with a participant's year of birth. Accordingly, the stated dollar-amount rule can be expressed as the covered compensation for the oldest participant or, if older, for the oldest individual who could become a participant during the current year under the plan's maximum age eligibility conditions.

Recall that the integration requirements track the benefit value placed on employer social security contributions.[10] The maximum bendpoint described above can be thought of as the wage level where social security benefits cease accruing. Accordingly, excess plans cannot deny accruals for pay levels above this bendpoint unless they compensate for the resulting proportionately lower value of social security benefits by decreasing the value of the integrated benefit. Consider a flat-benefit excess plan that defines its bendpoint as $18,000 but where the maximum covered compensation for anyone who is or could be a participant is $12,000. The maximum integrated benefit would be reduced as follows:[11]

$$37\tfrac{1}{2}\% \times \frac{\$12{,}000}{\$18{,}000} = 25\% .$$

The value of employer-provided social security is defined as 37½ percent of pay up to the $12,000 covered compensation amount. At $12,000

[7] See Revenue Ruling 71-446, secs. 5 and 6.

[8] Either term denotes the dollar amount at which the benefit formula increases the rate of accrual.

[9] See Revenue Ruling 71-446, sec. 2.03. Tables I and II (sec. 3.02) show the covered compensation based on the 1971 Social Security Act amendments. Revenue Ruling 78-92 updates these tables to the 1978 amendments.

[10] See Income Tax Regulations, sec. 1.401-3(e)(2).

[11] See Revenue Ruling 71-446, sec. 5.04, flush material.

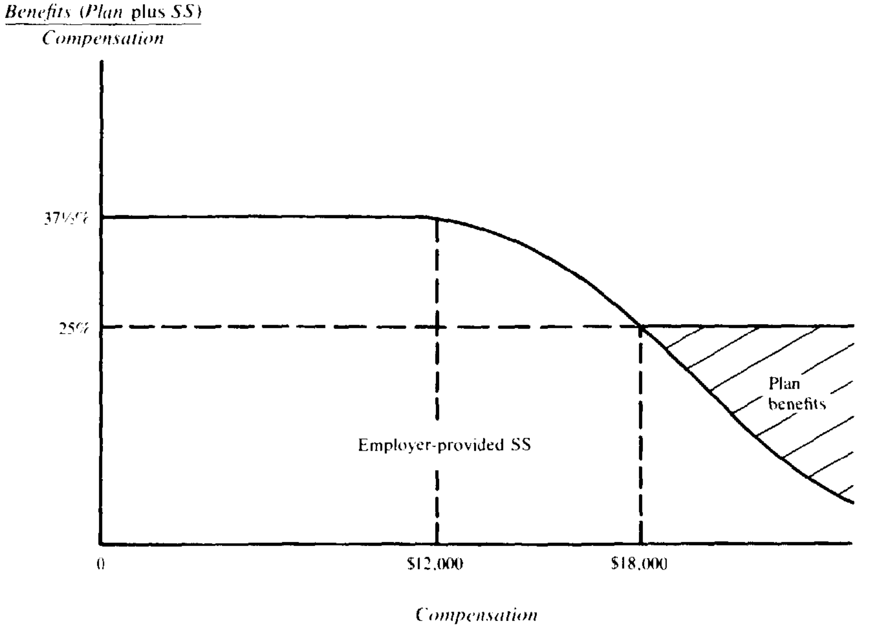

FIG. 3.—Reduction in integration limit because of bendpoint in excess of maximum covered compensation.

this translates into the equivalent of an annual benefit of $4,500. At $18,000, the point at which the integrated benefit kicks in, this same $4,500 has dropped to 25 percent of pay. Therefore, the maximum integration limit has to be reduced to 25 percent in order to avoid having benefits be relatively greater for higher-paid individuals. Figure 3 illustrates this reduction in integration limit. Of course, if, in this example, the bendpoint was set at any amount that did not exceed the maximum $12,000 covered compensation, no adjustment of the 37½ percent limit would be required.

UNIT-BENEFIT EXCESS PLANS

In establishing the equivalent limit for unit-benefit plans, the 37½ percent is deemed equivalent to 1 percent per year of service with no limit on service. The benefit formula is stated as

$$1\% \times \text{total service} \times (\text{high 5-year average pay minus covered compensation}) .$$

As with flat-benefit excess plans, covered compensation is the bendpoint or the integration level, and a bendpoint that is greater than the maximum results in reducing the 1 percent in the same fashion as described immediately above.

Both the 37½ percent and the 1 percent limits are intended for use with integrated plans that base benefits on "final" average pay. As indicated above, the basic requirement is that pay can be averaged over a period that is not less than five years. Revenue Ruling 72-276 indicates that a three- or four-year averaging period can be used, provided that the otherwise applicable limit (37½ percent or 1 percent) is multiplied by 90 percent or 95 percent, respectively, to restore balance with the value of employer-provided social security benefits.

There are plans, however, that base benefits on actual annual pay. Recognizing that this type of benefit formula is less valuable than one based on final pay, the 1 percent average pay integration limit equivalent was increased to 1.4 percent per year of service. The bendpoint for this type of arrangement, where the ultimate benefit is the accumulation over a participant's career of annual benefit accruals, is typically the annual FICA taxable wage base (TWB). The benefit formula for each year of service is stated as

$$1.4\% \times (\text{actual pay minus TWB}) .$$

Again, a bendpoint that exceeds the maximum results in requiring a reduction in the integration limit (1.4 percent), as outlined above.

The 37½ percent limit established by regulation and applied to flat-benefit excess plans is translated by Revenue Ruling 71-446 to a 1 percent and 1.4 percent limit for unit-benefit final average and career average plans, respectively. But under flat-benefit excess plans the maximum integration limit is 37½ percent regardless of whether benefits are based on career average or final average pay.

Offset Plans

With excess plans the rate of benefit accrual increases relative to compensation, and the same holds for offset plans. As we have seen, this "discrimination," which is in apparent conflict with the prohibited discrimination standard, is allowed, within limits established to allocate social security credit to plan sponsors.

With offset plans a nonintegrated formula, for example, 50 percent of "some"[12] pay or 2 percent times service times "some" pay, has a subtraction element or offset of a stated percentage of an individual's social security primary insurance amount (PIA). And it is only the offset that is subject to restriction under Revenue Ruling 71-446. Why is that?

PIA increases with pay up to an amount comparable to covered compensation and then remains fixed (i.e., maximum benefit). Beyond covered compensation, then, as pay increases, PIA decreases as a percentage of pay; in fact, PIA decreases as a percentage of pay with increasing pay even for earning levels below covered compensation. When a fixed portion of PIA is subtracted from a formula that is a uniform percentage of pay, the result is a benefit that increases with pay. Consider a benefit formula of 65 percent of pay minus 60 percent of PIA. Figure 4 shows the nonintegrated portion (65 percent of pay) and the PIA offset portion separately. For simplicity it is assumed that PIA is uniformly 50 percent of pay up to covered compensation. Figure 5 shows the resultant plan benefit

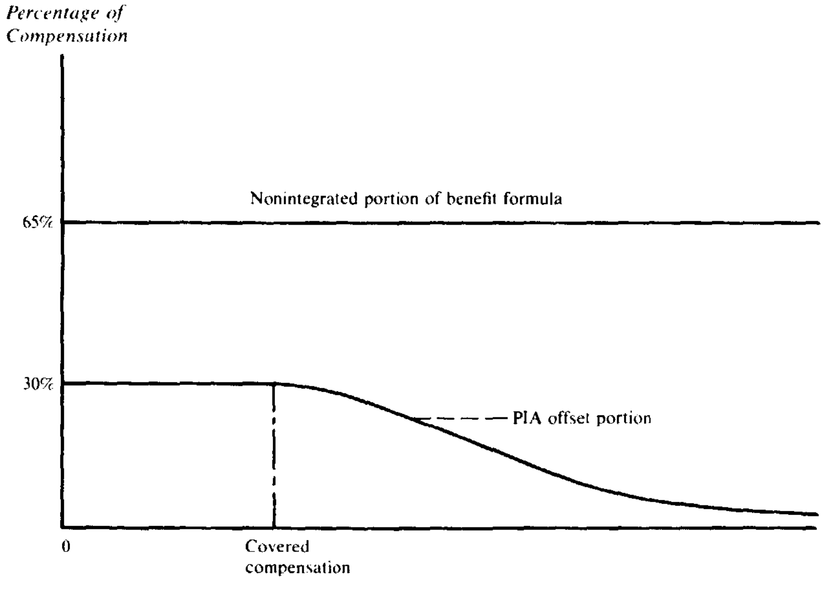

FIG. 4.—Two components of an offset plan benefit formula

[12] Since this portion applies uniformly to all participants, there are basically no restrictions on averaging, but the definition of pay—for example, base pay versus W-2 pay—may be restricted; see Revenue Ruling 71-26.

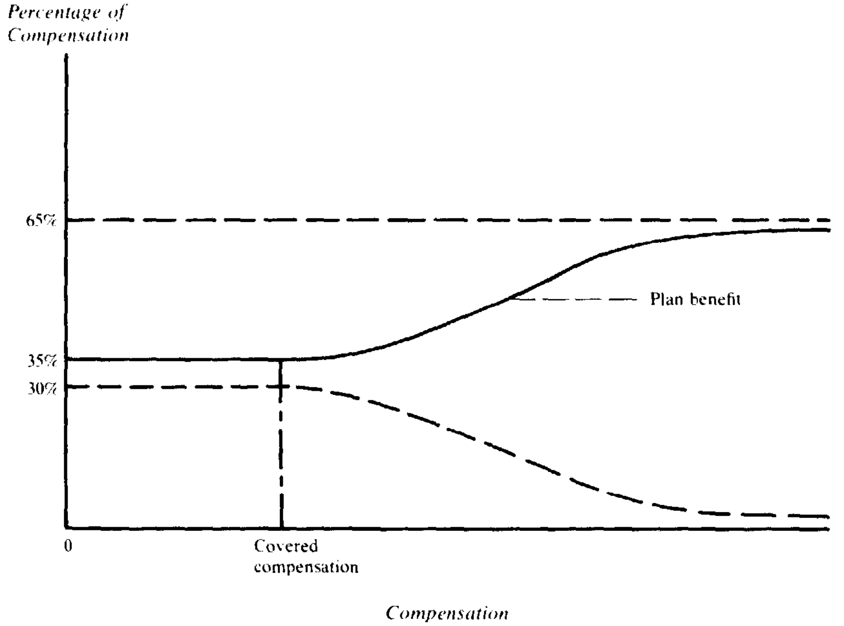

FIG. 5.—Plan benefit resulting from the components in Fig. 4

when the offset is subtracted from the nonintegrated portion. From this, the plan benefit can be seen to increase with pay.

The maximum permissible offset is 83⅓ percent of PIA, if the same plan design features that apply to excess plans are used: normal retirement at age 65, no ancillaries, and so forth. Employers and employees share the cost of social security. This implies that a plan sponsor should be given credit for 50 percent of PIA for his contributions. However, this would ignore the substantial value of ancillary benefits "bought" by FICA taxes (e.g., survivors' benefits). When these ancillaries are included, the value of social security benefits is deemed by regulation to be just over 160 percent of PIA, and 83⅓ percent was settled on as one-half of this amount. An offset plan that is fully integrated by using the maximum permissible offset can be seen to satisfy the prohibited discrimination standard when the value of employer-provided social security is added to the plan benefit, as follows:

$X\% \times$ pay *minus* $83\frac{1}{3}\%$ of PIA (offset) *plus* $83\frac{1}{3}\%$ of PIA (employer-provided social security benefit) $= X\%$ of pay .

If integrated ancillary benefits are provided, the 83⅓ percent limit must be reduced; the mechanics will be covered in the next section. The rationale is the same as provided for excess plans. The plan sponsor's credit is an absolute amount—83⅓ percent of PIA under a plan offering the standard design features. If an ancillary such as a preretirement death benefit of 100 times anticipated monthly retirement benefit (which increases the value of the net integrated retirement benefit) is included as a plan benefit, then the amount of integration, the offset, must be reduced in order to avoid tipping the scale in favor of plan benefits. If the death benefit increases the value of the net benefit by 11 percent, this necessarily implies that the value of the gross benefit and, more important, the value of the offset, have been increased by 11 percent as well. Since the *value* of the offset may not exceed 83⅓ percent of PIA, and the PIA is fixed, it is necessary to reduce the 83⅓ percent by 11 percent to compensate for the increase in value attributable to the death benefit. With reference to the offset diagram above, as an extreme example, if sufficient ancillaries were included to require the reduction of the offset to "zero," this would result in a plan benefit that is a level percentage of pay for all participants. This would increase the net benefit but decrease the extent of integration.

Revenue Ruling 71-446 sets out equivalencies for the value of employer-provided social security benefits as applicable to flat-benefit excess plans, final average and career average unit-benefit excess plans, and offset plans. These quantities are expressed as

37½% of covered compensation
= 1% of average pay up to covered compensation × service
= 1.4% of actual pay up to taxable wage base for each year of service
= 83⅓% of PIA .

V. ADJUSTMENTS TO THE MAXIMUM INTEGRATION LIMITS

To repeat, integrating a pension plan with social security is predicated on balancing the plan's benefits and the regulatory value placed on employer FICA contributions. When the plan benefit is made more valuable by upgrading one or more of the standard plan features, the otherwise applicable limit (37½ percent, 1 percent, 1.4 percent, or 83⅓ percent) must be reduced. The following will introduce the limit adjustments required when certain forms of death benefits, early retirement provisions, and several related provisions are provided in conjunction with integrated benefits.[13]

[13] See Revenue Ruling 71-446, secs. 8–13.

The general rule, expressed in various guises in Revenue Ruling 71-446 (for example, see sec. 8.03), for determining the adjustment required in the integration limit, when necessary, can be stated as follows:

The maximum limit must be reduced so that the (actuarial) value of the sum of (*a*) the value of the adjusted limit and (*b*) the additional value of the ancillary feature is equal to the value of the unadjusted maximum limit.

Let us see how this rule is applied.

Death Benefits

If the form of the retirement benefit[14] is more valuable than a straight life annuity, then a reduction in the otherwise applicable limit is required. Alternatively, if the unreduced form of benefit is straight life, and optional forms, such as a term certain guarantee or a joint and survivor form, are available on an actuarially reduced basis, no reduction is necessary, since there is no increase in the value of the benefit. The reduction, if required, can be accomplished by effecting equivalence between the actual benefit form and the maximum allowable integrated straight life annuity benefit. Section 9 in Revenue Ruling 71-446 provides a list of reduction factors that are deemed to satisfy the equivalence requirement (safe harbors) for various benefit forms.

The same reasoning applies for preretirement death benefits whether in the form of a lump sum or a survivor annuity. Safe harbors are given in section 8 for three types of lump-sum death benefits that historically have been very popular, especially in smaller individual contract plans and split-funded plans.[15] The otherwise applicable limit is multiplied by

1. Eight-ninths, if the death benefit is the retirement benefit reserve on a typical individual level premium funding method *and* no other death benefits are provided that the participant does not "pay" for.
2. Eight-tenths, if the death benefit is 100 times the anticipated monthly pension *and* no other death benefits are provided that the participant does not pay for.
3. Seven-ninths, if the benefit is the greater of the ones described in items 1 and 2 above.

If death benefits are provided under a retirement plan by means of an insurance policy, the term cost for the "pure" insurance element (face amount minus any reserve) is includable in the covered participant's gross income. That is, the participant is required to "pay" for the pure

[14] See ibid., sec. 9.

[15] Plan benefits are provided by means of life insurance contracts and an accumulating auxiliary fund.

insurance protection by including the cost in his gross income.[16] This means that if any of the three death benefits described above is provided by insurance policies, the reduction would be 8/9. The reserve would be the only plan-provided death benefit, since the participant pays, by inclusion in income, for any additional benefit.

Section 8.02 describes the adjustment required for a preretirement spouse's survivor's annuity; it also warns with a reference to Revenue Ruling 70-611 that, notwithstanding the reduction, the survivor's benefit must satisfy the requirement that death benefits be incidental by playing a "minor" role in the pension plan. The IRS has indicated[17] that no adjustment is required in the otherwise applicable integration limit for a plan that provides a preretirement survivor annuity required by section 401(a)(11)(C) of the Code.

These reductions apply uniformly to the equivalent limits (37½ percent, 1 percent, 1.4 percent, 83⅓ percent). For excess plans this would have the effect of reducing the otherwise available plan benefit. But the same result is not required for offset plans, since the required reduction can be applied only to the offset. This is not terribly troublesome from a design standpoint in the case of death benefits, but it can produce anomalous results in the case of early retirement reductions, as discussed below.

Early Retirement

EXCESS PLANS

The integration limit may be affected by early retirement provisions.[18] If a plan provides benefits in the event that an employee terminates prior to age 65, the integration limit is reduced to the extent that the benefit exceeds the value of the accrued benefit, determined by using the fractional rule,[19] payable at age 65. If follows, then, that no adjustment is required for unit-benefit plans, with no limit on service, providing for the payment of the accrued benefit commencing at age 65 or the actuarial equivalent at an earlier age. Similarly, flat-benefit plans that accrue benefits using the fractional rule would not require an adjustment.

Two separate reductions in the otherwise applicable limit may be necessary when benefits can begin before age 65. One mitigates the effect of an actuarial early-commencement subsidy, while the other offsets the

[16] See Revenue Ruling 55-747 for the so-called PS-58 costs.

[17] See News Release IR-1646, July 28, 1976.

[18] See Revenue Ruling 71-446, sec. 10.

[19] Projected benefit at age 65 assuming continuous service and constant pay, prorated on the basis of the ratio of actual service to projected service.

value added by accruing the full benefit before age 65. Section 10.021 gives a safe harbor for the actuarial equivalence reductions: one-fifteenth per year for the first five years and one-thirtieth for each of the next five years. In addition, if a flat-benefit plan allows for the full accrual of benefits before age 65, the otherwise applicable limit is reduced by the ratio of service at such earlier age to projected service at age 65.

Consider two flat-benefit excess plans, A and B. Each provides that the normal retirement benefit is fully accrued at age 62 for participants with at least fifteen years of service; otherwise the benefit is reduced pro rata on the basis of the ratio of years of service at age 62 to 15. Plan A provides that the accrued benefit is payable at retirement after age 62, while Plan B provides that the accrued benefit will commence at age 65.[20] It should be apparent that the integration limit will be lower for Plan A, since the benefit is more valuable.

The integration limit for Plan B is 31.25 percent. The maximum 37½ percent limit is multiplied by 15/18, reflecting the reduction that would be required using the standard plan features described above for an individual with fifteen years of service at age 62 (worst-case test).[21] The limit for Plan A reflects the increased value for early commencement, and is 31.25 percent actuarially reduced from age 65 to age 62. Using the one-fifteenth safe harbor rule, this works out to 25 percent.

Prior to the effective date for the minimum accrual requirements of section 411(b) of the Code, section 10.022 of Revenue Ruling 71-446 gave a safe harbor: one-twelfth for each of the first five years, one-twenty-fourth for the next five, combining the 1/15, 1/30 flat-benefit plan reductions required for early commencement and providing for a fully accrued benefit prior to age 65, as illustrated for Plan A above. This safe harbor was revoked by Revenue Ruling 75-480. The 1/12, 1/24 reductions, which contained a component for accruing a projected benefit, could violate the minimum accrual requirements of section 411(b) of the Code, if adopted.

OFFSET PLANS[22]

Early retirement benefits provided by such plans may require adjustments to the permissible offset. The circumstances under which adjustment is required, and the manner of application, are similar to those for excess plans. If the benefit is provided as a deferred annuity starting at

[20] A questionable design feature, but of some value as a pedagogical device.

[21] Under the standard criteria, the maximum (37½%) benefit cannot be fully accrued earlier than age 65 without reduction using the fractional rule. In this case the reduction, the ratio of actual service to projected service at 65, is 15/18.

[22] See Revenue Ruling 71-446, sec. 11.

age 65, then the offset must be "accrued" in one of two ways described in section 11.01. If benefits are available before age 65, the accrued offset must be actuarially reduced; the excess plan 1/15, 1/30 safe harbor is available as indicated in section 11.02.

If these required offset reductions were employed without modification, benefits payable at early retirement could exceed those at normal retirement. Plan sponsors usually employ various means to avoid such a result. For example, the actuarial reduction may be applied to the net benefit instead of the offset only.

DISABILITY BENEFITS[23]

If a plan provides disability benefits before age 65 and certain conditions are met, the otherwise applicable integration limit is reduced by 10 percent. Plan disability benefits must be conditioned on eligibility for social security disability benefits; otherwise the plan benefit is treated like an early retirement benefit and the early retirement reduction requirements are applicable. There is also a limit to the level of integrated disability benefit that may be provided. Under an excess plan the integrated disability benefit may not exceed the accrued benefit without reduction for early commencement or, if greater, 70 percent of the projected benefit payable at age 65. (See sec. 12.011.) For offset plans, the offset to the disability benefit cannot exceed 64 percent of the actual social security benefit determined upon disability retirement. If benefits are payable in the event of disability but are deferred to age 65, no adjustment is required.[24]

EMPLOYEE CONTRIBUTIONS

The integration limits are intended to balance the value of plan benefits and the value placed on employer FICA contributions. Section 13 of Revenue Ruling 71-446 indicates that the applicable limit for excess plans can be exceeded to the extent that any excess is provided by employee contributions. Of course, the same does not follow for offset plans, since an increase in the limit results in a decrease in the expected retirement benefit.

Sections 13.01 and 13.02 indicate that the rate of employee contributions can increase the 1.4 percent integration limit for career average unit-benefit excess plans by one-sixth of such rate, while the 1 percent final average limit can go up by one-eighth. Flat-benefit plans are treated sim-

[23] See ibid., sec. 12.

[24] See ibid., sec. 12.012, and Revenue Ruling 72-492.

ilarly, with the appropriate 1/6, 1/8 conversion rates applied to aggregate contributions. If benefits begin before age 65, credit given for employee contributions is actuarially reduced in the manner described in the early retirement section above.

Aggregate contributions for flat-benefit plans do not define a unique amount where varying lengths of service can qualify for the maximum benefit. The worst-case principle alluded to above suggests that the aggregate be defined for the shortest period of service required for a full accrual. Section 13 of Mimeograph 6641 indicates the same approach.

SAFE HARBORS

Revenue Ruling 71-446 gives various adjustment factors that are deemed to satisfy the general requirement that the integration limits must be actuarially reduced if certain plan features are included. Such factors were developed on the basis of assumptions deemed appropriate in 1971. Some of those assumptions presumably would continue to be appropriate today. Perhaps the underlying interest and mortality assumptions, however, might require reconsideration. Revenue Ruling 76-47 and the Code section 401(j) revenue ruling[25] contain similar adjustment factors but are based on assumptions that are more appropriate today. Logical extension would suggest that adjustment factors covering identical situations, published subsequent to 71-446, could be used as substitutes for the 71-446 safe harbors. Indeed, Revenue Ruling 80-253, which involves actuarial adjustment factors required in applying the limitations in section 415 of the Code, provides that the adjustment factors found in Revenue Ruling 71-446, Revenue Ruling 76-47, or the then existing section 401(j) proposed ruling are all deemed equally acceptable.

VI. WHAT'S NEXT

As mentioned earlier, the specifics of the integration rules have changed from time to time. Most of the changes have tracked changes in social security benefits. The 1972 and 1977 amendments to the Social Security Act significantly affected benefits, albeit in a somewhat offsetting manner. Each of these changes would suggest some modification in the integration details. However, for reasons touched on below, nothing has been published in this regard.

During the legislative process that culminated in the passage of the Employee Retirement Income Security Act of 1974 (ERISA), a provision that would have frozen private plan integration to 1971 levels until July

[25] See Revenue Ruling 81-57.

1, 1976, was seriously considered. This provision was ultimately dropped. Instead, the IRS was requested to refrain from issuing further integration rules until at least June 30, 1975.

In 1978 the Carter administration proposed legislative changes for the treatment of integrated tax-qualified plans. The proposal differed from the status quo in at least one substantive respect. It would have introduced a new element in the integration rules; benefit adequacy would have been added to the traditional requirement of equity. The proposal evoked a fair amount of public reaction and was not adopted.

In November, 1980, an interim report was issued by the President's Commission on Pension Policy. The report suggests that the current integration rules are quite complex and, more important, may "overstate the employers' cost of providing social security benefits."

In the past several years, commentators in various written and oral forums[26] have proposed changes in the integration rules that are aimed at minimizing the details and thereby reducing the current perceived complexity.

These developments suggest interest by rather disparate groups in taking a hard look at the rules that apply to integrated plans. It is true that the tension is in different directions, but it seems likely that with all of the interest being expressed, significant change in this area cannot be too far off.

VII. CONCLUSION

It was not my intention to offer any opinion as to the relative merits of the basic underlying assumptions used to arrive at the current integration rules. Furthermore, as stated at the outset, this presentation is not a substitute for a careful reading of the various source materials. Indeed, there are topics of Revenue Ruling 71-446 that have not been covered at all: defined contribution plans, multiple integration, and variable annuities, among others. Finally, it is hoped that the presentation proves to be of some assistance in making the rules more readily understandable.

[26] For example, see A. W. Anderson's paper in *TSA*, Vol. XXVIII.