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DESIGN OF INTEGRATED RETIREMENT PLANS

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The expectation is that principles of Social Security integration will change (or may already have changed).

- Anticipating Washington
- How can plans be designed to accommodate any changes?
- How can consultants advise clients in a period of uncertainty?
- Is the use of offset tables desirable and permissible?
- New developments (if any)

MR. STEPHEN OHANIAN: A retirement plan is integrated when plan benefits or contributions take Social Security benefits or contributions into account. Defined contribution plans are often integrated by using a formula which pays a higher amount for earnings in excess of the Social Security wage base. Defined benefit plans are often integrated by using a higher percentage for earnings in excess of an average Social Security wage base, or by offsetting a portion of the Social Security benefit.

We are here today to talk about plan design issues and how we should be advising clients with respect to integration. This also includes questions on how to calculate Social Security benefits under an offset-type plan. To do this, we need to get a handle on what the rules are likely to be in the future.

Current integration rules are too complicated and unfair. Some of the problems and inequities that have been addressed over the last several years include the following:

- Many defined benefit plans are integrated at levels which assume a complete earnings history. The reason for this assumption is administrative ease. But, many employees have not worked from age 21 until retirement. To the extent most of these employees are women, the use of the full earnings history assumption is discriminatory.

- Consider two employees, A and B, who have the same pay and service histories with the employer from which they retire. The employer has an offset plan. Employee A had lower earnings than B prior to their joining the employer. If prior employer earnings are counted, then A gets a higher pension than B since A's Social Security benefit is lower.

- Consider two employees, C and D, who have equal service histories and final average pay. But, C has lower career earnings than D. Employee C will get a higher pension than D.

- If a defined contribution plan integrates at a level lower than the wage base, middle income wage earners get proportionately more than the lower paid. This may be discriminatory. For example, if the wage is $35,700 and a formula which provides 5% under $10,000 and 10% over $10,000 is used, then a $10,000 employee gets 5% while a $20,000 employee gets 7½%.

- Defined benefit plans using the offset method do not calculate benefits in the same manner as the Social Security Administration. The Social Security Administration calculates a pension using earnings before the year of retirement and then adjusts the benefit the following year after earnings records are posted. Most defined benefit offset plans use a single amount and more than likely use an amount taking earnings in the year of retirement into consideration. This implies a larger Social Security benefit and therefore a smaller pension benefit.

- Employees who retire after normal retirement age will get an increase in their Social Security benefit (the delayed retirement credit). Should a plan using the offset method use the delayed retirement credit in the offset calculation? Some currently do if they include salary after normal retirement age in their definition of pay.

As a result of some of the problems stated above and others not stated, there have been several proposals and laws since Revenue Ruling 71-446.

- In 1978, the Carter Administration proposed changing the integration rules to provide more beneifts for the lower paid employee. The proposal essentially would have required lower levels of integration.

- In 1981, Congressman Erlenborn and Senator Nickles proposed changes that would have allowed integration based on income received (not cost), would have allowed integration up to 100%, and would have allowed plans to be tested separately. This proposal would have allowed plans to integrate at higher levels, i.e., to pay relatively more to higher paid employees and relatively less to lower paid employees. It is the only proposal (to my knowledge) that would have shifted integration in this direction. All other proposals coming out of Washington reduce the level of integration allowed.

- Last year Congressman Rangel introduced a bill that would have lowered the allowable limits on Defined Contribution integration to OASDI rate (currently 5.4%). The prior level was 7%. For defined benefit plans, the Rangel bill would have required using an annuity equivalent of the OASDI taxes paid by the employer on account of the particular participant (i.e., disallowing use of full earnings history). In order to placate some of the foes, the Rangel bill also had a safe harbor integration rule based on benefits. The thrust of the Rangel proposals was to change the integration rules from one based on benefits to one based on taxes paid.

- TEFRA was the result of the Rangel proposal. The defined contribution concept was enacted but the defined benefit rules were not because the Rangel proposals were too difficult to administer.

However, Congress agreed in principle with the Rangel proposal on defined benefit plans.

- In March of this year, Senator Dole wrote to Dr. Rivkin of the Congressional Budget Office asking that a broad look be taken at the effects of recent legislative changes. He also asked for a general examination of the federal pension laws. In his letter, Senator Dole noted that the private pension system rewards long service, fulltime employment and high pay levels (due to integration provisions). In contrast, he points out that public purposes are to encourage all individuals to save money. Public tax incentives should be focused on those least likely to save (e.g., lower paid and younger employees) and should be applicable to those in need (and not based on length of service). He also indicated that savings should be secure. Implications of the Dole request are far reaching. If public policy alternatives are enacted (in contrast to the retirement planning approach used by employers), we would see the end of integrated pension plans. We may, in fact, even see a further reduction in defined benefit retirement plans.

- The Social Security Admendments Act of 1983 made a few changes that affect integration rules. The retirement age was increased, the CPI adjustment was delayed and the delayed retirement credit was increased substantially. Of these, the increase in the retirement age is probably the most cumbersome. For example, a plan with normal retirement age of 65 must integrate with a reduced Social Security benefit. The alternative is to incrase the normal retirement age of the plan to match that of Social Security.

What does the future hold? Integration will still be allowed, but with severe cutbacks. The public policy issues raised earlier will slowly overtake the retirement planning concepts traditionally used. There

seems to be a definite shift in terms of the basis for integrations; from that of benefits to taxes paid (or the benefit equivalent of taxes). Defined contribution integration rules have already been changed to reflect this shift. There also seems to be a lot of emphasis toward using taxes paid by an employer on the behalf of the participant. This is the Rangel concept. Because of severe administrative problems with this approach, it would eliminate some of the defined benefit integrated plans.

How are we advising our clients? We should base current policy on current benefit objectives and current integration rules. But we should also be aware of future possibilities, especially as to changes that might be disruptive.

The table approach is appropriate for calculating Social Security benefits if integration is taking place at less than the maximum level allowed. If the maximum offset using the actual Social Security Benefit is lower, then this lower offset should be used. Calculating exact benefits is very cumbersome, time consuming and expensive, although the IRS seems to be leaning in this direction.

MR. DONALD J. SEGAL: The program introduces this topic by saying the expectation is that principles of Social Security integration will change (or may already have changed). I guess the planners of the program were a little bit optimistic in terms of the government's moving to meet changed conditions. That really involved a rather large supposition if you consider that the government integration regulations that we are operating under at the present and have been operating under for the last 12 years are those contained in Revenue Ruling 71-446 as modified by a handful of subsequent revenue rulings. In essence there have been no major changes in theory or approach since that revenue ruling. A a matter of fact, the approach to integration goes back even farther than that-Revenue Ruling 71-446 really being a restatement and modification of Revenue Ruling 69-4; and 69-4 was floated to the surface in 1968.

If you consider that there were major changes in the Social Security Act in 1973 and 1977 without any major changes in the integration regulations to anticipate a rapid move on the part of the government because of the enactment of the Social Security Amendments of 1983 is not a reasonable expectation. There are many other laws that have been enacted since 71-446 which have an effect on integration and which have not caused the government to act with any speed. Just to list a few of them, there are ERISA, TEFRA and ADEA. So in answer to the question, how do you anticipate Washington, I wouldn't. I think the real challenge is to answer the question, how do you design a plan with maximum flexibility to accommodate any changes that have already taken and that might take place.

In dealing with clients the major approach should be in defining his objectives and working within the current environment; but at the same time trying to perceive what the trends are.

To begin with, let's review some of the basics that are in Revenue Ruling 71-446 so we can answer the question, how do you design an integrated retirement plan in today's environment? The two magic numbers in Revenue Ruling 71-446 for defined benefit plans are 37½% and 83-1/3%. The maximum permissible excess benefit under an integrated flat benefit excess plan is 37½% of final average earnings in excess of covered compensation. The maximum permissible offset is 83-1/3% of the employees old age insurance benefit under the Social Security Act. There have been some questions raised as to what that means. Let me skip ahead a little. Recognizing that the age of entitlement to 100% of the primary insurance amount is going to increase to age 67 under the Social Security amendments, some people have questioned whether you could use the total Social Security benefit without recognizing what is payable at 65. However, if you read on in 71-446, Section 11, dealing with early retirement under offset plans, uses the phrase, "old age insurance benefit to which the employee would be entitled at age 65". Therefore, it is quite clear that when we are dealing with a design of pension plans, we should be dealing with the old age insurance benefit that would be payable at age 65.

Of course questions come up now and then as to how the 83-1/3% was arrived at. The explanation given when the code was originally amended was that the other benefits in addition to the old age benefit, namely the death benefit, the disability benefit and the spouse's benefit, had a value of 62% of the old age insurance benefit. Therefore the total benefit was equal to 162% of the old age benefit. Since the employee and employer contributions are equal, then you should really take half of that to recognize the employer portion, or 81%. The 81% is rounded to 83-1/3%. In the twelve years since the Revenue Ruling was published, I have been unable to explain to anyone how you round 81% up to 83-1/3%.

Some of the other important distinctions regarding excess plans versus offset plans is that in excess plans, if you are averaging earnings over fewer than 5 years (such as 4 years or 3 years) you have to make an adjustment to the maximum permissible excess benefit. An offset plan has no such requirement. You can, if you wish, use actual final earnings. In excess plans you cannot use fewer than 3 years. An excess plan requires that you use consecutive years, whether it be 3, 4, 5 or more. There is no such requirement in an offset plan. You could use the highest 5 of the last 10; not necessarily the highest consecutive 5 of the last 10. Finally, under excess plans you are permitted to increase the maximum permissible excess benefit by a percentage of the excess employee contributions. Since Revenue Ruling 69-4, no such adjustment has been permitted under offset plans, although the IRS has always maintained an open mind on the issue. If you can come up with an acceptable method for making this adjustment, they will be perfectly happy to look at it.

Now what are all these laws that have had an effect on the design of the pension plan and what specific elements of the law should we pay attention to. There has been a general trend toward the lowering of retirement ages. This trend will probably be reversed as a result of economic conditions, the part of ADEA that prohibits mandatory retirement prior to age 70 except under certain limited conditions, and the recent enactment of the changes in the Social Security law which will raise the normal retirement age under Social Security. The age at which you can receive the full benefit will increase at age 66 for those born in 1943 and later, and then eventually to age 67 for those born in 1960 and later. The first people affected will be those born in 1938 and later; their retirement age will be 65 2/12.

How do we deal with these changes in the Social Security Act in designing a pension plan? There are some people who have said that they expect the normal retiremnt age in pension plans to be increased

as a result of the Social Security amendments. My reply to them is, "not so fast". There is a little law on the books called ERISA, which states that the normal retirement age is the later of attainment of age 65 or the 10th anniversary of employment. Pension plans cannot change the normal retirement age to an age higher than age 65 unless ERISA were first amended. Considering the legislative history of ERISA and the number of proposed changes that have been thrown into the hopper in Congress since ERISA was enacted, I really would not like to make any prediction as to when, if ever, the normal retirement age under ERISA will be changed. One must not lose sight of the fact that the changes in the Social Security Law that were enacted were basically fiscal changes, rather than well thought out design changes. So you still have plans with the normal retirement age of 65.

In designing an offset plan, it should probably be quite clear that if the normal retirement age is 65, the Social Security benefit to which the offset percentage applies should be defined as the Social Security benefit payable at age 65 under the Social Security Law in effect at the date of retirement or termination.

There is another question that may arise. There are new early retirement factors under Social Security. Prior to the new law, if you retired at age 62 the reduction was consistent with the reduction factors published in Revenue Ruling 71-446. The 1/15-1/30 rule was deemed to be an actuarial equivalent. Under Social Security you couldn't retire prior to age 62. The reduction factors are now 1/15th for each of the first three years prior to normal retirement age under Social Security and 5% for each of the next 2 years. This means that for normal retirement age of 67, the recipient would be entitled to 86 2/3% of the benefit at age 65, 80% at age 64, 75% at age 63 and 70% at age 62.

Would there be a problem if you had a plan that was integrated to the maximum and you defined the Social Security offset at ages 62, 63 and 64 as being equal to the benefit that would be payable under Social Security? The factors given in Revenue Ruling 71-446 give you 93.3% at age 64. The ratio of 80% to 86-2/3% is 92.3%. At age 63 it's 86.7% and 86.5% in realty. However at age 62, the law says 80%, but the ratio of 70% to 86-2/3% is 80.8%. Therefore have we a problem at age 62. Will we be offsetting by too high a benefit? This is a question that should be addressed. My own preference in designing a plan is to define the Social Security benefit as that estimated by the Plan Administrator; then apply the plan early retirement factors which, for the sake of this discussion, let us assume are the 1/15th, 1/30th factors.

Let's pause for a minute and consider some of the changes which have been considered in the integration laws. Needless to say these changes would have had a significant effect. I think upheaval is a more accurate term-if any of them were adopted. In 1978 a trial balloon was launched whereby if you had a flat benefit excess plan or a unit benefit excess plan, the percentage of benefit in excess of the integration breakpoint could not be greater than 1.8 times the percentage you were providing below the breakpoint. The obvious aim of this proposal was to eliminate excess only plans because 1.8 or 5 or 10 times zero is still zero.

That 1.8 was subsequently modified to 2% in a second trial balloon but fortunately the gondola never got off the ground. Another part of that proposal was that the offset percentage could not exceed the percentage of final earnings that was being paid under the plan formula. Under that formula you could have a 100% of final average earnings. If the maximum final average earnings was 50%, then the maximum offset could only be 50%.

In the congressional discussion that preceded the enactment of TEFRA, Mr. Rangel's original bill had changes in integration for both defined benefit and defined contribution plans. As you are aware, the defined contribution proposal was enacted, limiting the excess contribution over the wage base on defined contribution plans to the amount of OASDI taxes paid, or 5.4% when it was enacted and it will be 5.7% in 1984. His proposal for defined benefit plans can only be described as a hornet's nest. It was to accumulate the FICA taxes paid at interest to retirement, and convert it to a benefit purchase under regulations prescribed by the Secretary of the Treasury. This would have represented a major change in theory for integration of defined benefit pensions plans. Integration of defined benefit plans has historically been on a value of benefits basis. Rangel's proposal would have changed that to a cost basis. Fortunately it wasn't enacted. There would have been tremendous administrative problems and that is an understatement. Among the faults of this proposal were that it did not recognize that there is income redistribution that takes place in Social Security. The lower paid employee receives more of a benefit for his taxes than does the higher paid employee. Under his bill both the lower paid and the higher paid would have received the same benefit measured as a percentage of his earnings.

TEFRA had an impact on integration in another way. Under the top heavy rules, if a plan is deemed to be top heavy, you will be required to provide a non-integrated benefit to the non-key employees. I feel I should mention this, as it is sort of a side issue under the topic of design of integrated retirement plans.

What are some of the other inequities that we are faced with right now in designing an integrated retirement plan? If someone came to me and said design an integrated retirement plan under today's environment, I would propose an offset plan. The changes in the Social Security Act

that have taken place, most particularly the 1977 changes, have produced a significant discrepancy between excess plans and offset plans.

The maximum permissible excess benefit for a life retiring in 1983 is 37½% of earnings in excess of covered compensation. For someone attaining age 65 in 1983 the average covered wages or covered compensation is $11,892. 37½% of that is $4,460. That number is a lot less than the current maximum PIA which is approximately $8,500. Taking the maximum permissible offset, 83-1/3% of that number is approximately $7,100 or about $159% of the amount of benefit that is excluded under the excess plan. Thus, there is a lot of the Social Security benefit that you are not permitted to recognize in the exess plan. If you try to equate the two of them, the appropriate covered compensation would be approximately $18,900. What has happened is that offset plans have adjusted to changes in the law but excess plans have not.

If you consider a person retiring at age 65 in 1983 who had earned at least the wage base in each year, the benefit he would receive is 23.8% of the current wage base of $35,700. If you recalculated the benefit using the 1983 breakpoints, the benefit would turn out to be approximately 29% of $35,700. It is expected that the replacement ratio at the wage base will stay fairly level around 29%. But if you analyze the new formula, which is 90% up to the first breakpoint, plus 32% up to the second breakpoint, plus 15% of the excess over that, you will see that the PIA formula is non-level. If your average covered wages were equal to the second breakpoint under the 1983 formula, the retiree would receive 41.6% of his average covered wages. I mention this just to illustrate the discrepancies between flat excess plans and offset plans. But, at least the offset plan does permit some recognition of changes in the Social Security law.

What are some of the other problems we face in designing a plan in today's environment? We have to be a little careful of ERISA. Revenue Ruling 78-252 pointed out that when designing an offset plan, you must be careful not to violate the benefit accrual tests. For example, you cannot have a formula that will provide 2.4% of final average earnings times all years of credited service minus 2.4% of the PIA times credited service subject to a maximum of 25 years. That formula satisfies none of the 3 benefit accrual tests. That is just a caution. Something else that actuaries have to worry about. ERISA states quite clearly in Section 1013A, which amended Section 412 of the Internal Revenue Code, that changes in benefits under the Social Security Act are to be considered an actuarial gain or loss. If you are using a spread gain funding method, you must spread it over future normal costs. If you are using an immediate gain funding method, the amortization period is 15 years.

Another effect I have noticed regarding both the 1977 and the 1983 changes in the Social Security Law is that there has been a noticeable effect on the benefits of terminated vested employees in offset plans. As a result of the change in formula in 1977, there was significant decrease in the amount of projected Social Security benefit when you are calculating benefits based upon the assumption of level earnings to age 65. The old multi-step formula which had both increasing wage base and cost of living in it provided much higher projected benefits than the new formula, with its 15% maximum percentage. Although the PIA benefits expected at retirement were anticipated to be fairly close, within 10% of each other, the deficiency was to be made up for by future indexing and future cost of living increases. The result was that the projected PIA benefits on the current formula for a young person were very low. With the 1983 amendments, if you have someone with a Social Security retirment age of 67, you now have to apply the new early retirement factor to get his benefit at age 65. The effect of both of these was an increase in the accrued benefit to the vested

terminated employee at a small but probably not very significant increase in funding costs of the plans.

Is the use of offset tables desirable and permissable? It is most definitely desirable and I certainly hope it is permissible. In terms of plan design and plan administration believe in the KISS method-Keep It Simple, Stupid. I believe that the use of a table, where the plan administrator can just look up the projected Social Security benefit for any plan participant, is much more desirable than trying to get actual wages. When you are talking about actual wages you have several questions. Do you use just the wages while the person was employed with that particular plan sponsor or do you use his entire Social Security earnings history? If you are using the actual Social Security benefit, that may recognize earnings from a second job, the table approach would not recognize the second job earnings. Perhaps the most significant question, is how do you get timely information if you wanted to calculate his benefit on an exact basis. This is especially important when you consider that you have 60 days to provide a participant with a statement of his accrued benefit. And it is undesirable to go back and correct the benefit being paid when you finally are in receipt of the actual benefit he is receiving. If you are purchasing benefits from an insurance company, either under individual contracts or under a group contract, there can be many undesirable consequences of making a correction.

The only new developments I anticipate are new integration regulations. Considering the amount of regulations that will be required as a result of TEFRA, I don't think that changes in integration regulations are very high on the agenda in Washington. Until then I'll deal with what we have now while providing flexibility so that any changes that have to be made would not have any major impact on plan design or plan costs.

Let me close by asking this question. Given the choice, would you rather have new integration regulations (considering the way Washington is thinking), or would you rather just deal with 71-446? I know what I have. I don't know what I'll get.

MR. BARNET N. BERIN: Any study of IRS integration theory is really a study of replacement rates, starting with the rates generated by the primary Social Security benefit. Comparing this curve of replacement rates of a permitted maximum curve of combined replacement rates (primary Social Security benefit plus private pension plan benefit) defines an acceptable integrated private pension plan. Integration isn't a study of "taking something away" but a study of acceptable methods of coordination.

To qualify for tax deduction, a pension plan must not discriminate in favor of employees who are highly paid. In determining whether an employer's plan meets this test, the IRS takes into account the benefits provided under Social Security. If Social Security and private plan benefits, taken together, do not favor higher-paid employees, the plan will be approved. I have omitted reference to "employer-provided or employer-financed" Social Security benefits because the two checks received in retirement can be tested directly for discrimination in favor of the higher-paid employees without creating layers of complexity. On this basis, it is possible to simplify the IRS integration test considerably.

Under IRS integration, the test involves a consideration of replacement rates - their shape and slope. Notice that this does not involve the employer-financed Social Security benefits, which has become an arbitrary designation, since Social Security is pay-as-you-go with some real and some proposed general revenue financing. The last is a bit euphemistic if the budget is in a deficit position.

Personally, I prefer simple solutions rather than complex solutions to problems: they are easier to understand and therefore easier to apply and longer-lasting, but they are very difficult to get accepted. Traditions die hard and slowly - change and tinkering become preferred as the only practical means to effect change. Nevertheless, the "Cap" is interesting since it has the ability to solve the problem of coordinat-

ing pension plans with Social Security benefits either as a maximum benefit or as the normal form of benefit.

So far, the Cap is a maximum benefit applicable at retirement. In simplest terms, the pension plan benefit is reduced if the pension plan benefit plus the primary Social Security benefit is too high in relation to final annual salary. Typically, the test compares the pension plan benefit plus primary Social Security benefit against a percentage of final average salary. If the combination is higher than (say) 85% of salary, the pension plan benefit is reduced. This is also the general sense of the IRS rule on integration. (More on the fact that the Cap includes 100% of the primary Social Security benefit later.)

The test is sensible. In retirement, you draw two checks: the pension plan benefit and a primary Social Security benefit. Therefore, testing the combination of pension plan benefit and Social Security benefit is appropriate. As to the 85%, more work should be done to assess the validity of a single percentage as measured by retirement needs. We do know that income needs generally decrease after retirement:

- Social Security is free from income tax (federal, in part, state and city in full).
- Social Security benefits are indexed, permitting increases, but not decreases.
- Job-related expenses are eliminated.
- There are double personal income tax exemptions for persons over age 65.
- A lower overall tax bracket is effective in retirement.

The 1983 Social Security Amendment introduced taxation of some retirement benefits. On the surface, 85% of final average salary seems a fair but rigid maximum. Perhaps the percentage for the lowest-paid employee should be higher than the percentage for the highest-paid employee; in other words, some sort of grading from, say, 90% for lower-paid employees to 60% for the highest-paid employees. Some definition of "basic gross earnings" or "standardized net earnings" would be useful in this conection. Without grading, there may be a plan design problem in that the Cap may principally effect the low-paid, long-service employees. The result, in terms of distribution of actual retirements, should not discriminate in favor of the higher-paid employees. This becomes close to the essence of the IRA rules on integration.

Any Social Security spouse benefit is ignored in this test. A limit which might reduce an individual's private pension plan benefit should not include a possible spouse's Social Security benefit if for no other reason than marital status can change by divorce or by death.

The Cap started in 1974-75, in collective bargaining, when it was inserted in several major settlements in the aluminum, steel and cooper industries. Since then a small number of salaried plans, as well as hourly plans, have adopted this form of maximum benefit.

Philosophically, it is interesting to find the Cap in both salaried and hourly pension plans. Over the years, in certain industries, hourly wage distributions for older employees have become less concentrated and show a greater range from low to high salary. The flat-dollar pension plan for hourly employees makes most sense if wages are concentrated so that pensions, as a percentage of pay, do not vary greatly at retirement.

With the Cap in both salaried and hourly pension plans, the salary and hourly plans are drawn closer together. This could be useful since it may become less feasible, in future years, to have one pension formula for salaried employees and a different pension formula for hourly employees.

However, there is a basic technical problem with the Cap. The concept does not now satisfactorily meet the IRS tests for coordinating pension plan benefits with Social Security. Revenue Ruling 71-446 requires plans to coordinate with a percentage of the primary Social Security benefit.

To meet Internal Revenue Service rules, the Cap must be changed to:

- a maximum Social Security benefit of 83-1/3% and not 100%. (With ancillary benefits, the 83-1/3% would be reduced further.)

- a graded percentage limit for all employees retiring and verification that the Cap does not discriminate against low-paid employees by review of employees affected. This goes to the crux of the IRS integration problem: removing any possibility of discrimination by salary level.

It should be apparent that it is not productive for a compnay to offer a combined retirement income (private Pension plan benefit plus Social Security benefit) which exceeds the employee's preretirement salary. Ideally, both companies and unions have a common interest in avoiding excessive pension spending to the detriment of compensation or other areas of benefits.

It is important that the basic components of the Cap, the future combination of pension plan benefit plus primary Social Security benefits, be designed to provide adequate retirement income. The maximum must be reasonable.

There are some hurdles in plan design, beyond IRS qualification. What to do at early retirement and at vested termination of employment? Should the Cap become the normal form of pension benefit? What about contributory pension plans? How about short-service participants? While there are no established practices, the solutions to these problems are not serious obstacles to the Cap's future. The administrative problems involved in introducing the test appear surmountable.

The Cap, if accepted by both employers and unions, could avoid the Internal Revenue Service coordination problems in designing pension plans that reflect Social Security benefits. To some, Revenue Ruling 71-446 is an awesome document, very complex, inhibiting certain ancillary benefits, and therefore to be avoided by designing simplistic plans or by removing any connection with Social Security. If the Cap is generally accepted, the complex rules will no longer be so important. The employer who wants to use a straight 2% pension formula can avoid generating excessive benefits at retirement by installing the Cap, for example.

It probably is of limited value in a well-designed, final-pay Social Security offset pension plan, since the Cap is literally a final-pay, 100% offset plan. This is apparent if we take the Cap and restate it in an equivalent manner:

> Pension plan benefit plus primary Social Security benefit divided by final salary must be less than or equal to 85% (say). This is the same as pension plan benefit must be less than or equal to 85% of final salary less primary Social Security benefit. This maximum benefit is a final-pay, offset pension plan.*

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*If we start with a pension formula of 70% of final salary less 83.3% of primary Social Security benefit and increase each term by 20%, we have 84% of final salary less 100% of primary Social Security benefit. In this example, the Cap can be viewed as providing 20% more benefit than the integrated formula. Approaches like this can be used to design 100% offset plans under the present IRS rules.

Another possibility would be to make the Cap the normal form of benefit and do away with Revenue Ruling 71-446 and its proposed family of similar rules. For example, the new integration method would operate by "grandfathering" all accrued pension benefits and by making a test of replacement rates at plan qualification and amendment, using projection benefits at normal retirement age with and without future salary scale increases. At actual retirement date, all accrued pension benefits would be brought together and the test made. The pension plan benefit prior to retirement would be the recipient of any reduction. Alternatively, a pro rata approach might be used.

As a practical expedient, two rules would be added:

(1) no Social Security offset pension plan would be permitted to deduct more than 83-1/3% of the primary Social Security benefit prior to the date of change;

(2) no step-up pension would increase more than 1.4% at the Social Security maximum taxable wage base.

Integrated ancillary benefits, such as survivor and disability benefits, could be based on a maximum of the normal benefit formula. Allowing projected normal benefits, rather than accrued benefits, would become a social decision and not an integration decision.

These additional rules should ease the period of transition, since they are familiar benchmarks within the present method and would prevent radical departures from present plan designs.

As distinguished an actuary as Robert J. Myers, when he was chief actuary of the Social Security Administration, commented on pension plan integration as follows: "In my view, the Internal Revenue Service has, over the years, developed its rules for integration of private pension plans with Social Security in a quite arbitrary and capricious

manner. A considerable amount of mathematical computations has often been made under conditions and hypotheses assumed so as to come out with a desired result, ofter consistent with what had previously been in effect."

It appears possible to design a method based on the Cap which is fair, operable, and capable of being understood by the many diverse groups that are interested in pension plans.

DISCUSSION NOTE --

Issue Before IRS
on
Calculating Social Security Benefits in Offset Plans

Prepared by: William J. McDonnell

May 18, 1983

Background

Many final earnings pension plans are integrated with Social Security by direct offset of a percentage of the employee's Social Security benefit. In these plans, the Social Security benefit is often estimated by using the earnings history with the current employer and an estimate for other years, or even by basing the estimate on only the final average salary or the final salary, assuming the employee was covered under Social Security for a full working career. In some cases the estimating procedure is described in the pension plan document, although in many cases it is merely in administrative practice. Many plans which describe the estimating procedure have been approved by local IRS offices. One such plan has been published in Prentice-Hall.

An IRS reviewer challenged the practice of estimating the Social Security offset on the authority of Revenue Ruling 71-446 and subsequent integration rulings, taking the position that the actual Social Security earnings history must be used. These earning records may be obtained at a reasonable cost from the Social Security Administration. Without using the actual Social Security earnings history, an employee's pension might be offset by a percentage of the actual Social Security benefit which exceeds the maximum allowable offset described in Revenue Ruling 71-446. Obvious examples of those who could be affected are women reentering the work force and employees whose previous employment consisted of many years of non-covered employment, such as with the federal government.

The employer involved in this challenge requested technical advice from the IRS National Office.

IRS Tentative Decision

After considering the issue for well over a year, the National Office responded with a tentative decision as follows (my wording):

> An estimate of the Social Security benefit using imputed earnings would be acceptable if the following two conditions were met:
>
> (1) Imputed wages are estimated using either a constant percentage not less than 6% or the percentage increases in the Social Security average taxable wages.
>
> (2) The participant would have the right to have his benefit adjusted if he furnished information on his actual FICA wage record.

In telephone conversations with an IRS actuary, it was learned that:

- The IRS is interpreting Sec. 2.07 of Rev. Ruling 71-446 and the reference to Social Security benefit in the vesting regulations (1.411(a)-7) to mean the employee's actual Social Security benefit, making this a discriminiation issue and a forfeiture issue.

- The 6%, which might not be appropriate in this employer's situation, was arrived at because of other similar cases currently under IRS review in an attempt to come up with a general rule for all cases.

- The employee would have to be given "at least a few years" during which he could present his actual earnings and have his benefit adjusted. It was admitted that this could cause funding problems.

Technical Advice Conference

The IRS first looked at the problem from a purely theoretical viewpoint, and satisfied themselves that in fact there could be discrimination, since the intent of the discrimination rules appeared to measure the percentage of earnings replacement for highly-paid versus low-paid employees when their actual pensions are combined with their actual Social Security benefits. They also interpreted the vesting regulations to only permit forfeitures in offset plans to the extent a participant's actual Social Security benefit increased from one year to the next. They used as an example a participant who failed to accumulate 1,000 hours of service in a plan year, where no credit is given for a year in which less than 1,000 hours are accumulated, and whose estimated Social Security benefit increased by more than his actual Social Security benefit.

Having decided on a purely theoretical basis that the Social Security benefit used in the offset formula must be the actual Social Security benefit, the IRS considered the practical aspects of requiring all of the employers with offset pension plans to obtain earnings histories from the Social Security Administration for all employees separating from service with a benefit entitlement. Not wanting to impose an administrative burden of this magnitude upon so many employers, they came up with the tentative decision which puts the burden on the employee to obtain the information from the Social Security Administration if he wishes to dispute the company's estimate. The suggestions was to include wording in the Summary Plan description similar to the following:

"The Company uses an estmating procedure to calculate for Social Security for your entire working career. If this calcualtion was made using your actual Social Security earnings, it is unlikely that your Social Security benefit would differ appreciably from the estimate, unless there were several years after your 21st birthday when you either did not work at all or worked in employment not covered by Social Security, such as work with the federal government. If you wish to obtain a year-by-year record of your covered earnings from the Social Security Administration, you may bring this information to the Personnel Department and your retirement benefit will be recalculated using your actual Social Security earnings."

The IRS felt that very rarely would an employee ask to have his benefit recalculated, and this procedure would not involve a great deal of extra administrative burden.

The employer representatives made the following arguments against the discrimination and forfeiture issues.

- How can there be prohibited discrimination in this employer's offset formula when it is permissible to discriminate in favor of highly-paid employees to a greater extent under an excess plan?

- How can it be discriminatory to provide two employees with exactly the same earnings and service record at the employer with exactly the same retirement benefit?

- The rules permit imputing full coverage after termination of employment if the offset is prorated for service. Does not the proration technique account for the fact that the employer only provides for that pro-rata portion of the employee's Social Security benefit? If the offset were prorated by the fraction of service with the employer to 30 or 35 years, does not this in fact

produce a lower offset than if one assumed no prior covered earnings other than with that employer, and no proration?

- If a forfeiture could occur assuming the rules refer to actual Social Security benefits, such instances are rare and occur only under very unusual circumstances and involve very small amounts. These circumstances do not warrant imposing a severe administrative burden on employers to police these rare occurances.

Employer representatives spoke concerning the administrative burden. The contention was that the employer would not tolerate a system which put a burden on the employee to decide his best interest in a matter as complex as this one. At present, the employer engages in extensive counseling with employees who are retiring, which would be increased considerably with the need to explain the employee's choice regarding the computation of his Social Security benefit. Under such a system, the sophisticated employee, who would tend to be higher-paid, would understand the issue and make the right choice, while the low-paid employee would not be able to grasp the concepts despite extensive counseling, and would do nothing. For this reason, there would be built-in discrimination in such a system, if not illegal, certainly not moral. It would be completely unsatisfactory as an employee relations practice. The employer would end up obtaining earnings information for everyone to take this burden off the individual employee.

Employer representatives discussed the issue of fiduciary responsibility, not feeling as if the statement in the Summary Plan Description would suffice to discharge that responsibility. The employer would never be safe from law suits challenging the amount of pension due an employee, no matter how long the employee had been retired. The introduction of the IRS recommended language into the Plan and the SPD would open up the possibility for law suits over amounts of pension which had been determined even before the language was introduced.

In a written memorandum to the IRS following the technical advice conference, the employer submitted additional information relative to the severe administrative burden which would result if the IRS maintained its position, the risk of tort liability from following the suggested IRS procedure, the administrative burden which would be placed upon the Social Security Administration due to a large increase in the number of requests for individual earnings histories, and precedents in court decisions and other IRS positions which appear to be inconsistent with the IRS position in this matter.

Intercession by E.R.I.C.

The ERIC Treasury Committee has begun to actively participate in the discussions on this issue on behalf of several of their members who are concerned about the possible outcome. On April 20, ERIC representatives participated in a meeting at the IRS Naitonal Office with representatives of other interested parties.

In a memorandum to the ERIC Treasury Committee following the meeting, it was reported:

> "In summary, the meeting was inconclusive. The Service representatives based their concerns principally on section 411 and seemed to dismiss the argument that no impermissible forfeiture results from calculating benefits on the basis of reasonable estimates rather than actual Social Security earnings. They seem, nevertheless, to be concerned that the Service not create undue administrative problems for plans. I sense that their present position is importantly influenced by pressures (real or imagined) from women's groups, but that publication of a formal position is not imminent, and that, although it is most likely that the Service's position will be announced eventually in a published ruling, even that is not decided.

"More specifically, the present Service thinking is to permit benefits to be calculated on the basis of reasonable "backward" salary projections except in those cases where the participant presents actual Social Security earnings. Participants would have to be given a "reasonable" opportunity (most likely after termination) to provide those earnings, but what is a "reasonable" opportunity would depend on the facts and circumstances.

"The requirements would apply prospectively only, as losses would be treated as experience losses for funding purposes, and required amendments to plans and SPDs would be deferred (probably until such time as other amendements were made or required).

"Service personnel understand that the Social Security Administration would provide actual earnings to employers upon request without requiring employees to join in the requests, that requests and responses could be handled on magnetic tape, and that some "nominal" charge would be imposed by the SSA. We have not tried to verify any of this with SSA. It was also indicated that the DOL would have to decide if any employer could collect from participants the cost of obtaining information from the SSA.

"Your reactions would be appreciated. More specifically, if, notwithstanding our strong objections, a proposal along with foregoing lines were adopted, would you, at the least burdensome time (perhaps when benefits first vest), obtain actual earnings and, thus, preclude the possibility of having to make adjustments after determining benefits (or making lump sum distributions) on the basis of estimates? Alternatively, it was suggested that employers might be able to use actual Social Security earnings with respect to participants' employment by them but would be required to assume that there were no prior earnings from other employers. Your reactions to this alternative would also be appreciated.