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Health, Education, and
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July 6, 1998

The Honorable Barbara B. Kennelly
Ranking Minority Member
Subcommittee on Social Security
Committee on Ways and Means
House of Representatives

Subject: Integrating Pensions and Social Security: Trends Since 1986 Tax Law Changes

Dear Ms. Kennelly:

Prior to 1986, pension plans could combine (integrate) pension and Social Security benefits and qualify for favorable income tax treatment. The Tax Reform Act of 1986 (TRA86) modified the integration provision in the tax code.[1] You asked us for information on the impact of the 1986 change in the integration provision, including information on how integrated plans were modified to conform with the new provision and on trend data relating to integrated plans. To provide this information, we interviewed officials at the Internal Revenue Service (IRS) as well as cognizant pension actuaries and a benefits rights advocate; obtained data from the IRS, the Bureau of Labor Statistics, and actuarial and benefits consulting firms; and reviewed studies on pension integration. We conducted our work between March and June 1998 in accordance with generally accepted government auditing standards.

BACKGROUND

To encourage employers to establish pension plans for their employees, the Congress provides favorable tax treatment under the Internal Revenue Code (IRC) for pension plans that meet certain requirements,[2] including not

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[1]Public Law 99-514 (Oct. 22, 1986).

[2]Favorable tax treatment allows (1) plan sponsors to deduct (within certain limits) current plan contributions from their business income taxes, (2) earnings from plan investments to accumulate tax free, and (3) employees to avoid including pension contributions in taxable income until a distribution is made.

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discriminating in favor of highly compensated employees in coverage, contributions, or benefits.[3] The IRC contains special rules and tests to determine whether discrimination is occurring. There are two primary ways to satisfy the nondiscrimination rules (rules that are among the most complex in the tax system)–the nondiscrimination "general test" and special provisions that allow the plan to satisfy the nondiscrimination rules if the plan's design meets certain requirements.[4] One of these special provisions applies to integrated pension plans.[5]

The general test allows flexibility in plan design but is difficult to apply and must be performed periodically. The special integration provision is more restrictive in plan design but easier to apply, and nondiscrimination requirements do not have to be revisited until either the plan design or the law changes.

The Revenue Act of 1942,[6] which was enacted shortly after Social Security began providing benefits, allowed plans to integrate their pension benefits with Social Security. Because Social Security's benefit formula favored (and continues to favor) lower-paid employees, it was advantageous for plan sponsors to combine (integrate) Social Security and pension benefits when determining whether discrimination existed or not. As long as the combined Social Security and pension benefits did not replace a higher percentage of compensation for highly compensated employees at retirement than for lower-paid employees, these integration advantages allowed plan sponsors to provide higher pensions, relative

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[3]Under current law, a "highly compensated employee" is one who had either a 5-percent ownership interest in the company sponsoring the pension plan at any time during the year or the preceding year or compensation for the previous year in excess of $80,000 (indexed for inflation).

[4]The special provisions that demonstrate compliance with IRC requirements are called "safe harbors."

[5]For this document, integrated plans are defined benefit pension plans and either money purchase or profit-sharing defined contribution plans. Defined benefit plans pay specific pension amounts on the basis of a formula that generally includes job tenure or earnings, or both. In defined contribution plans, employers establish an account for each employee and may make a specified contribution to that account each year. Employee contributions are sometimes allowed or required.

[6]Public Law 77-753 (1942).

to compensation, for highly compensated workers and reduced the cost of providing pensions.

Integration of Social Security and pension benefits was controversial. Often-used justifications for this policy were that (1) in addition to pension contributions, pension plan sponsors also paid half the cost of Social Security; (2) private pension and Social Security benefits should not be duplicative; (3) without integration, some low-paid workers could have received combined pension and Social Security benefits exceeding their preretirement earnings; and (4) it was a way of compensating higher-paid workers for Social Security's progressive benefit formula that favored lower-paid workers. Critics of pension integration generally dismissed these justifications and cited the point that workers with low lifetime earnings received low retirement income from Social Security benefits even with the program's progressive benefit formula. They did not believe the workers' pension benefits should have been reduced as a result of this progressivity because the combined benefits from the two sources did not always provide a decent retirement income. Some critics believe integration should be eliminated altogether.

In 1971, the IRS authorized two methods of pension integration–the offset method and the excess method–and put some limits on the extent to which pension benefits could be reduced. Under the offset method of integration, a specified proportion of the employee's Social Security benefit was subtracted from the initial pension benefit amount.[7] Under the excess method, the plan provided benefits at a lower rate for compensation below a specified amount–the "integration level"–than above it.[8,9] Under either method, integration caused some lower-paid workers to lose all of their pension benefits.

TRA86 changed the rules, including the integration provision, that prohibit plans from favoring highly compensated employees. The new integration provision

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[7]Under the offset method, plans could reduce accrued pension benefits by up to 83.33 percent of a worker's Social Security benefit.

[8]The integration level is a specified amount that can be no higher than Social Security's taxable wage base (the maximum level of earnings that are subject to the Social Security payroll tax).

[9]Plans using the excess method allowed a benefit of up to 37.5 percent of compensation over the specified integration level but were not required to provide any pension benefits for workers whose compensation was always below the integration level.

requires that the plan treat all participants uniformly and establishes floors below which pension benefits cannot be reduced.[10] This provision also restricts the allowable amount of offset and limits the allowable pension accrual rate above the integration level relative to that below it.[11] Plan sponsors who use the integration provision in their plan design ensure that all participants receive some pension benefits. Under what is known as the "general test,"[12] which tests the amounts of accrued benefits and not the formula for determining benefits as the special integration provision does, there are few limits on the amount of integration that can be considered by the plan's benefit formula.[13]

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[10]See IRC sec. 401(l). Regulations implementing the new provisions did not fully take effect until the 1994 plan year.

[11]The provision limits the pension offset, which is generally no longer tied to Social Security benefits, to a maximum of 50 percent of the accrued pension benefit in offset plans. In defined benefit excess plans, the maximum accrual rate may not be more than twice the base benefit percentage (the accrual rate for compensation below the integration level), and the integration level may not exceed the amount of Social Security-covered compensation. In defined contribution excess plans, the maximum contribution rate for compensation above the integration level in effect each year may not be more than twice the contribution rate for compensation below that level. Other components of the TRA86 integration provision can further reduce the maximum allowable levels by which highly compensated employees can be favored.

[12]See IRC sec. 401(a)(4) and the corresponding regulations.

[13]Under the general test, a benefit accrual rate or a contribution allocation rate is determined for each employee. Employees are then grouped according to their accrual or allocation rates, and each group is tested to see if it covers a nondiscriminatory group. A separate rate group exists for each highly compensated participant in the plan and consists of that participant and all other participants (whether highly or not highly compensated) with equal or greater accrual or allocation rates. Employees can be included in more than one rate group. A plan passes the general test if each rate group satisfies the coverage rules contained in IRC sec. 410(b). (Dan M. McGill and others, Fundamentals of Private Pensions, 7th ed. (Philadelphia, Pa.: University of Pennsylvania Press, 1996), p. 79.

IMPACT OF TRA86 ON INTEGRATED PLANS

The actuaries and studies we consulted indicated that TRA86 may not have had an immediate impact on many integrated plans because in 1986 these plans appeared to already meet the new integration provision. In 1986, most plans using the offset method of integration generally reduced pension benefits by no more than 50 percent, and relatively few excess plans used a formula that withheld all benefits from the plans' lower-paid workers. However, many of these plans may not have been in compliance with other components of the TRA86 special integration provision and required some adjustment to their designs.

For plans not already in compliance with the new TRA86 integration provision, plan sponsors' reactions to TRA86 varied. Sponsors of some of the plans changed the design of their plan to comply with the new integration provision. Other plan sponsors either terminated their plans or used the general test to prove their plans were nondiscriminatory.

TRA86 increased plan costs for those sponsors who had to modify their plans to comply with the new integration provision. According to the actuaries we interviewed, many of these sponsors complied with the new rules because the general test was considered too complex and costly. Over time, the IRS finalized its rules and regulations pertaining to the general test, and actuaries gained a better understanding of the complexities of the test. Also, computer programs that test plan designs under alternatives by which the general test can be satisfied have become available. As a result, an increasing proportion of sponsors of integrated plans are using the general test, even though initial cost remains high, because it offers design flexibility that can reduce the sponsors' yearly contribution costs. Actuaries we talked with indicated they expect this shift toward the use of the general test to continue.

The IRS conducted a targeted study of integrated defined contribution plans for fiscal year 1993 to determine whether they complied with the TRA86 pension integration provision. It found that 3 of the 80 plans it audited required changes to bring them into compliance. The IRS is now conducting a targeted study to determine the level of compliance with the new integration provision for defined benefit plans. This study is expected to be completed during the current fiscal year. The IRS also indicated to us that it tries to ensure such compliance when it issues determination letters approving plan designs and as part of its ongoing audits of defined benefit plans.[14]

THE PERCENTAGE OF PENSION PLANS THAT ARE INTEGRATED UNDER IRC SEC. 401(l) IS DECLINING

Data from surveys conducted by private employee benefit consultants[15] show a decline in the proportion of pension plans that are integrated. For example, data from one consultant, the Hay Group, show that in 1988, 84 percent of plans in the sample were integrated–57 percent used the offset method of integration, and the other 27 percent used the excess method. A 1997 survey by the Hay Group indicates the percentage of integrated plans had fallen to 66 percent and the most common integration method shifted from offset to excess. Forty-nine percent of the surveyed plans (almost double the 1988 percentage) used the excess method in 1997, while the percentage using the offset method fell dramatically to 17 percent. Data from a KPMG Peat Marwick survey support this trend. Its data show that the percentage of integrated plans in the sample populations declined from 47 percent in 1994 to about 36 percent in 1997.

THE PERCENTAGE OF PARTICIPANTS COVERED BY INTEGRATED PLANS IS DECLINING

Bureau of Labor Statistics (BLS) data show that the percentage of participants in large and medium private firms covered by integrated defined benefit plans declined from 62 percent in 1986 to about 51 percent in 1995. (See fig. 1.) Its data also show a decline in the percentage of participants covered by plans using the offset method of integration. In 1986, 43 percent of participants were covered by offset plans. By 1995, offset plans covered only about 14 percent of participants. The percentage of participants covered by excess plans increased from 23 percent to 37 percent during the same period.

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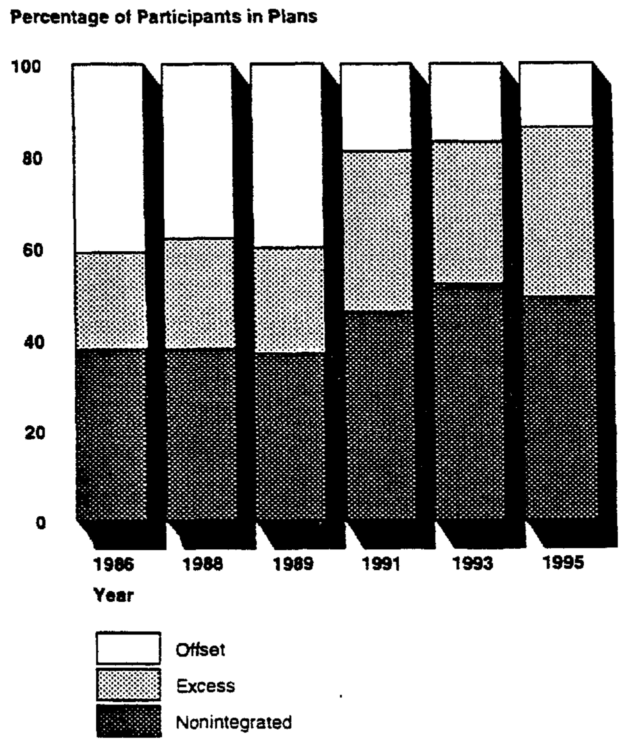
[14]A letter of determination is an advance written determination by IRS on whether a plan conforms to IRC requirements and is eligible for favorable tax treatment.

[15]Care should be taken in interpreting the figures based on these surveys because the sample of firms surveyed often is heavily weighted toward the consultants' own customer base, and therefore does not constitute a random sample of plans. These surveys are indicative of changes in many medium and large plans that tend to use the services of these consultants, however.

Figure 1: Decline in Percentage of Participants in Integrated Plans



Source: BLS surveys of employee benefits in medium and large private firms.

NEW INTEGRATION PROVISION MAY NOT BE AS EFFECTIVE AS DESIRED

It is unclear whether the TRA86 integration changes are working as intended, in part because plan sponsors can use the general test to avoid the special integration provision restrictions. According to IRS officials, the TRA86 changes clearly prevent plans from eliminating employees' pension benefits through integration if they adhere to the TRA86 integration provision. However, they acknowledged that a plan whose integration formula exceeded the integration provision restrictions could remain qualified by passing the general test. Some of the actuaries we interviewed said that some plan sponsors kept their pre-TRA86 integration formulas and used the general test to demonstrate nondiscrimination. Plans passing the general test can not only be heavily integrated but may cover less than 100 percent of employees.[16] Thus, the actuaries indicated, it is possible for plan sponsors to design plans that fail to cover large numbers of employees and can substantially reduce or even eliminate benefits for lower-paid employees. Nonetheless, neither the actuaries nor the benefit rights advocate we contacted were able to provide any specific examples of benefits being eliminated by integration, and we found no examples in the literature we reviewed.

AGENCY COMMENTS

We requested that IRS officials review a draft of this correspondence. They provided no substantive comments; however, they did make technical comments, which we have incorporated where appropriate.

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As arranged with your office, we will make copies of this correspondence available to interested parties.

If you have any questions about this letter, please contact me on (202) 512-7215. Major contributors are Francis P. Mulvey, Assistant Director; Michael D. Packard, Evaluator-in-Charge; and George A. Scott, Senior Evaluator.

Sincerely yours,

Cynthia M. Fagnoni

Cynthia M. Fagnoni
Director, Income Security Issues

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[16]See IRC sec. 410(b) for minimum coverage requirements.

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