

PENSION OFFSETS:

SOCIAL SECURITY INTEGRATION;
OTHER PENSION OFFSETS IN
QUALIFIED PENSION PLANS

WHAT WE WILL COVER

- **What is an offset?**
- **Social Security Integration**
 - What is it?
 - What do we need to know to advise clients?
 - Theory and history of integration
 - Integration in Defined Contribution Plans
 - Integration in Defined Benefit Plans
 - How to identify problems
 - When to refer clients elsewhere

WHAT WE WILL COVER

- **Other Offsets**
 - Floor-offset arrangements
 - Frozen benefit arrangements
 - Worker's compensation offsets
 - Tort award offsets
 - Unemployment benefits
 - Suspended early retirement benefits
 - Overpayments

WHAT IS AN OFFSET?

- **Pension plans must provide a definitely determinable benefit—in defined benefit plans, a formula provides benefit at retirement**
 - Example: 2% of final pay times years of service
 - Example: \$100 per month times years of service
- **Formula might include an offset or reduction relating to income from other sources**
 - Basic plan formula might include an offset or reduction relating to benefits from other sources (for example, worker's compensation payments or disability payments)
 - Social Security integration is special species of offset and applies to both defined benefit and defined contribution plans (where employer contribution to plan rather than benefit can be considered offset)
 - May also have reverse offset, where benefits under other plans are offset by retirement benefits

PART I: SOCIAL SECURITY INTEGRATION

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- **Basic theory of Social Security integration**
 - [Employer-funded] benefit from private pension plan +
 - [Employer-funded] portion of Social Security benefit =
 - Single, integrated (employer-funded) benefit

PART I: SOCIAL SECURITY INTEGRATION

• **Social Security integration generally permissible under Title I of ERISA but can result in violation of non-discrimination rules under Internal Revenue Code by providing larger benefits/contributions as percentage of compensation for highly compensated employees**

- If plan covers only non-highly compensated employees, integration permitted without restriction
 - permissible to provide 100% reduction in benefits by Social Security benefit
- Section 401(l) of Internal Revenue Code provides rules (and limits) on permissible Social Security integration when plan would otherwise violate non-discrimination rules

PART I: SOCIAL SECURITY INTEGRATION

• **Theory of Social Security Integration by Example**

- Employer contributes 5.7% of each employee's wage base compensation to pay for Social Security retirement benefits
 - Employer contributions calculated on compensation up to Social Security taxable wage base
 - In 2017, the taxable wage base is \$127,200

PART I: SOCIAL SECURITY INTEGRATION

• **Theory of Social Security Integration by Example**

- Employer contributes 5.7% of each employee's wage base compensation to pay for Social Security retirement benefits
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PART I: SOCIAL SECURITY INTEGRATION

• Theory of Social Security Integration by Example

- Illustration of Integrated Plan
 - N earns \$100,000, employer pays \$5,700 to Social Security to pay for retirement benefits (5.7% of compensation)
 - H earns \$254,200, employer pays \$7,250 to Social Security to pay for retirement benefits
 - 5.7% of first \$127,200 of compensation (wage base) but 2.85% of total compensation
 - Employer sets up defined contribution plan to which it contributes 5.7% of compensation in excess of wage base
 - makes 0 contribution for N, makes \$7,250 contribution to H (5.7% of \$127,200)
 - Plan in isolation looks discriminatory—\$7,250 contribution, or 2.85% of compensation for H, 0% of compensation for N
 - But in plan and Social Security integrated, employer contributions 5.7% of compensation for both N and H
 - [The above example would fail the section 401(l) integration rules, which do not permit complete integration]

PART I: SOCIAL SECURITY INTEGRATION

• Theory of Social Security Integration by Example

- Can integrate either a defined benefit or defined contribution plan with Social Security
 - in defined benefit plan, offset benefits rather than contributions
- Some argue that integrated plans, even with limitations under section 401(l), should be prohibited, rejecting theory that it is appropriate to integrate private pension plans with public social insurance
 - Nancy Altman argued that only one form of integration should be permitted: reduction of defined benefit plan if plan benefit plus Social Security benefits would exceed 100% of final pay

PART I: SOCIAL SECURITY INTEGRATION

• Brief History of Social Security Integration

- Prior to 1988, was permissible for an employer to integrate plan so that non-highly compensated employees received 0 benefit from the plan
- The TRA of 1986 modified rules restricting permissible integration; in only rate situations can employee's benefit be reduced to 0.
 - basic limitation is 2:1 rule—benefit/contribution above integration level cannot be more than twice benefit/contribution below the integration level
 - rules (in section 401(l) effective for plan years beginning in 1988)
- Permitted disparity concept

PART I: SOCIAL SECURITY INTEGRATION

• Integration of Defined Contribution Plan

- Plan provides integration level, typically Social Security wage base
- Employer contributes a base percentage on all compensation +
- An additional percentage on compensation in excess of integration level
- Excess percentage cannot exceed the lesser of
 - 5.7%
 - or the base percentage

PART I: SOCIAL SECURITY INTEGRATION

• DC Example I

- Integration level is \$127,200
- Base percentage is 4%; excess percentage is 4%
- N earns \$120,000
 - employer contribution: \$4,800 to DC plan,
- H earns \$254,400
 - employer contribution to DC plan
 - 4% of \$254,000, or \$10,176, plus
 - 4% of 127,200, or \$5,088, for a total of
 - \$15,264
- Employer contributes 4% of total compensation for N, 6% of total compensation for H, to the DC plan.

PART I: SOCIAL SECURITY INTEGRATION

• DC Example II

- Integration level is \$127,200
- Base percentage is 8%
 - excess percentage limited to 5.7%
- N earns \$120,000
 - employer contribution: \$9,600,
- H earns \$254,400
 - employer contribution
 - 8% of \$254,000, or \$20,352, plus
 - 5.7% of 127,200, or \$7,250.40, for a total of
 - \$27,602.40
- Employer contributes 8% of total compensation for N, 10.85% of total compensation for H, to the DC plan.

PART I: SOCIAL SECURITY INTEGRATION

• Defined Contribution Plans

- If integration level is set below wage base, the 5.7% figure is reduced
- Plan can have multiple integration levels
- Cannot have integration level in excess of wage base
- Must use statutory definition of compensation, which generally includes overtime and bonuses
- Discretionary profit-sharing plan formula is complex when integrated with Social Security.

PART I: SOCIAL SECURITY INTEGRATION

• Defined Contribution Plans

- Permitted disparity: plan does not have to comply with section 401(l) in form if benefits for highly compensated are not more favorable than they would have been if plan satisfied section 401(l) in form.
 - Common to use permitted disparity approach in age-weighted defined contribution plans

PART I: SOCIAL SECURITY INTEGRATION

• Defined Benefit Plans: Overview of Rules and Principles

- Complex rules
- Integration method for DC plans based on integrating employer contributions to private plan and Social Security
- Integration method for DB plans based on integrating benefits from private plan and Social Security

PART I: SOCIAL SECURITY INTEGRATION

• Defined Benefit Plans

- Two methods for defined-benefit integration
 - Step-rate, aka as excess rate method
 - Offset method

PART I: SOCIAL SECURITY INTEGRATION

• Defined Benefit Plan—excess or step-rate method

- Benefit accrual rate for compensation above integration level ("base rate")
- Benefit accrual rate for compensation above integration level ("excess rate")
 - no more than greater of
 - ¾% or
 - base rate
- Integration level based on "covered compensation," which is average of wage base for 35 years ending at participant's Social Security retirement age
 - Regulations provide alternative methods for setting integration levels

PART I: SOCIAL SECURITY INTEGRATION

• Excess-method DB Plan Illustration

- 1% of final average compensation up to integration level, plus
- 1.75% of final average compensation above the integration level

PART I: SOCIAL SECURITY INTEGRATION

- **Defined Benefit Plan—offset method**
 - Benefits first calculated based on final average annual compensation
 - Benefits so calculated reduced by offset allowance
 - offset is for benefits below offset level
 - Offset cannot reduce benefit more than 50%

PART I: SOCIAL SECURITY INTEGRATION

- **Offset Method DB Plan Illustration**
 - Plan formula:
 - 2% of final average compensation times years of service,
 - reduced by .75% per year, up to 35 years, times final average compensation below offset level
 - P has \$50,000 final average compensation and 10 years of service
 - Assume offset level for participant in excess of \$50,000
 - Benefit: \$10,000, less \$3,750, or \$6,250
 - [Benefit must not be reduced more than 50%]

PART I: SOCIAL SECURITY INTEGRATION

- **Defined Benefit Plan—Offset by Percentage of Social Security**
 - An offset-type plan, but reduces plan benefit by percentage of participant's Social Security benefit

PART I: SOCIAL SECURITY INTEGRATION

- **When to refer client elsewhere**
 - If client is having problems with Social Security Administration rather than plan
 - If client wants estimate of Social Security benefit
 - Pro bono actuary can sometimes be of assistance in determining whether benefit was correctly calculated and complies with integration rules

PART II: MISCELLANEOUS PLAN OFFSETS

- **Types of Offsets**
 - Offsets from governmental programs, such as worker's compensation or unemployment compensation
 - Offsets from employer-sponsored disability plans
 - Offsets from a defined contribution plan
 - often called floor-offset arrangements
 - Offsetting defined benefit formulas
 - Offsets from other sources of retirement income
 - Offsets from suspended early retirement benefits
 - Offsets to recoup overpayments

PART II: MISCELLANEOUS PLAN OFFSETS

- **Worker's Compensation Offsets**
 - Some pension plans, particularly for blue-collar workers, include provisions offsetting pension by worker's compensation payments
 - Example: "in the event of any benefit, which the committee or the claims administrator, as applicable, shall determine to be of the same general character as a benefit provided by the plan, the excess only, if any, of the amount prescribed in the plan under the amount of such payment . . . shall be payable under the plan."
 - Does such a provision cause a non-permissible forfeiture of an accrued benefit, or violate either definitely determinable requirement, or requirement that plan provide pensions (wage substitute)?

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Worker's Compensation Offsets**
 - IRS has consistently rules that such offsets are permissible, see, e.g., Rev. Rul. 68-243, 1968-1 C.B. 157.
 - Supreme Court has approved of such offsets: *Alessi v. Raybestos Manhattan, Inc.*, 451 U.S. 504 (1981).

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Worker's Compensation Offsets**
 - Open question: must award be in nature of wage replacement?
 - IRS has consistently ruled that pension cannot be offset by portion of award
 - designated for medical payments
 - designated to compensate for loss of bodily function
 - important to designate award clearly for these purposes
 - *But see Reska v. Pension Plan of Bethlehem Steel Corporation*, 848 F.2d 372 (1988) (benefit may be offset by lump sum award for 20% hearing loss, reserving question of whether worker's compensation award must be in nature of wage replacement).

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Worker's Compensation Offsets**
 - How to evaluate legitimacy of offsets
 - **Is compensation award received in lump sum?**
 - if so, did plan have formula to convert lump sum into equivalent monthly payments? was formula reasonable?
 - **Is retirement-age pension offset by compensation award received prior to earliest possible retirement age?**
 - may not be permissible to offset retirement benefits in such cases, particularly if plan language does not clearly provide.

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Worker's Compensation Offsets**
 - How to evaluate legitimacy of offsets
 - **Does offset include attorney's fees paid by participants?**
 - unless plan has clause specifically providing that offset includes attorney's fees, plan probably must reduce offset amount by such fees, see *Southwestern Bell Corp.*, 341 F.3d 696 (8th Cir. 2003); also *US Airways v. McCutchen* (medical subrogation in health care plan), 133 S.Ct. 1537 (2013).

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Worker's Compensation Offsets**
 - How to evaluate legitimacy of offsets
 - **If worker's compensation monthly payments exceed monthly pension and worker's compensation stops, can future pension benefits be reduced by "unused" worker's compensation payments?**
 - probably, but can argue that plan must clearly provide (many plans will not clearly provide for this).
 - in any event, may be argument that does not apply to survivor's annuity, since this is separate benefit

**PART II:
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OFFSETS**

- **Unemployment Benefits**
 - IRS has ruled that unemployment benefits cannot offset pension benefits because pension plan is not permitted to pay unemployment benefits
 - Rev. Rul. 78-178, 1978-1 CB 117: "The issue is whether unemployment compensation benefits together with qualified pension plan benefits establish an integrated and correlated retirement system . . . Only those programs which provide benefits that may be provided under a qualified pension plan may be used as an offset since only then could a correlated retirement system exist."

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Tort Awards Offsets**
 - IRS has ruled that such payments cannot offset pension benefits because employer does not contribute to the award
 - But permissible in health benefit plans

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Employer-Provided Disability Benefits**
 - Some pension plans include such offsets for disability benefits
 - important to read plan language
 - Some disability plans include offsets for pension benefits
 - See *Day v. AT&T Disability Income Plan*, 698 F.3d 1091 (2012), cert denied, 133 S.Ct. 210 (2013) (disability offset by prior lump sum payment from pension plan)
 - Could disability plan benefit be offset by defined contribution plan balance or distribution?

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OFFSETS**

- **Floor-Offset Arrangements**
 - Defined benefit reduced by value of defined contribution account
 - Steps in calculating benefits under floor-offset plan
 - calculate defined benefit without offset (A)
 - convert defined contribution account into equivalent annuity benefit (B)
 - plan will provide assumptions for the conversion; does not have to conform to section 417 assumptions
 - benefit equals A-B
 - can reduce defined benefit to 0

**PART II:
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OFFSETS**

- **Floor-Offset Arrangements**
 - Cash-balance plans can be used in floor-offset arrangements—either to offset a traditional defined benefit plan or as the primary benefit that is offset by a linked defined contribution plan
 - 401(k) plans may not be used in offset arrangements
 - but profit-sharing plans may be used
 - DC plans that hold stock are subject to 10% limit on stock ownership (but there is grandfather provision for pre-1987 plans)

**PART II:
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OFFSETS**

- **Floor-Offset Arrangements--Questions**
 - **Is annuity conversion formula reasonable?**
 - **When was offset added?**
 - Offset cannot reduce benefits accrued before offset added to plan, but can be subject to wear-away.
 - **Was plan frozen or terminated?**
 - If so, did the plan freeze the offset provision at time of retirement?
 - How is the plan calculating benefit offset at termination?
 - **Did participant receive distribution from dc plan prior to retirement?**
 - **Did participant delay normal retirement age?**
 - When is account value for purposes of offset?

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Offsetting defined benefit provisions**
 - Defined benefit formula is reduced by benefit received in a separate defined benefit plan or an annuity received from other plan.
 - Single defined benefit plan has two formulas, participant receives larger of two benefits.
 - Wear-away: benefit formula is frozen and replaced by new benefit formula. Participant receives larger of two benefits.
 - PPA generally bars wear-away in cash balance conversions.

**PART II:
MISCELLANEOUS PLAN
OFFSETS**

- **Other Sources of Retirement Income**
 - *Bonovich v. Knights of Columbus*, 146 F.3d 57 (2nd Cir. 1998).
 - Pension plan for insurance agents offset benefits by renewal commissions, which court held serve same purpose as pension benefits, i.e., wage replacement.

**PART II:
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OFFSETS**

- **Suspended Early Retirement Benefits**
 - some negotiated plans permit payment of early retirement benefits if retiree is not employed in industry
 - Retiree accepts job that disqualifies retiree from future early retirement benefits
 - Some plans offset future benefits by amount of early retirement benefits received prior to accepting disqualifying position; plan must be explicit in this regard.
 - When plan adds a suspension provision, it can be an impermissible reduction of previously accrued benefits.

**PART II:
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OFFSETS**

- **Recoupment**
 - Plan overpays participant due to plan error
 - Plan offsets future benefit until overpayments are recouped
