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N. James Turner

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QUALIFIED PENSION AND PROFIT SHARING PLANS: INTEGRATION WITH SOCIAL SECURITY*

N. JAMES TURNER**

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I. INTRODUCTION

One area of federal taxation in which individual as well as corporate taxpayers have realized substantial tax savings has been that of deferred compensation. The primary objective of deferred compensation from the standpoint of the individual taxpayer is the deferment of the payment of a tax on a benefit presently received to some future time when his income bracket is lower. The most widely used vehicle of deferred compensation in recent years has been the qualified pension and profit sharing plan. The reasons for the popularity of such a plan[1] are the various benefits provided by the Internal Revenue Code (Code) to both employers and employees who participate in it.

Briefly, some of the tax advantages available are: (a) an immediate tax deduction to the employer for contributions made to the plan;[2] (b) income and gains of the plan itself are generally exempt from tax;[3] (c)

* The Employee Retirement Income Security for Employees Act of 1974 was signed into law on September 2, 1974. Pub. L. No. 93-406 (Sept. 2, 1974). This Act deals primarily with the administration, funding, vesting and eligibility requirements for pension and profit sharing plans and, with one exception, will have no direct effect on the topic of integration of pension and profit sharing plans with Social Security. See footnote 74 *infra*.

** Third-year law student, University of Miami; Concentration in Taxation and Corporation Law.

1. For convenience of expression and for the purposes of this article, the terms pension and profit sharing plan will be used interchangeably. The differences may be found in Treas. Reg. § 1.401-1(b) (1956) and will be discussed briefly in this article.

2. INT. REV. CODE OF 1954, § 404(a).

3. *Id.* § 501(a). A tax will be imposed on the income and gains from the plan that are considered unrelated business income. *Id.* § 511.

covered employees are not taxed on employer contributions made on their behalf until they actually receive or have an unrestricted right to receive funds from the plan;[4] (d) certain lump-sum distributions are treated as long-term capital gains or are subject to a special ten year averaging device;[5] and (e) distributions from a qualified plan payable to an entity other than the estate of the employee are exempt from estate taxes to the extent that they represent employer contributions.[6]

Qualified pension plans generally fall within two categories. The first type, a money purchase plan, is one in which the employer makes fixed annual *contributions* on behalf of each employee based upon a percentage of the employee's salary. At retirement the employee receives a pension equal to the sum of employer contributions made on his behalf plus any appreciation that may have been realized through the investment of those contributions.[7] The second type is the defined benefit plan which provides that the employee will receive a definite dollar *benefit* at retirement. The amount of the defined benefit may be stated in terms of a fixed dollar amount or a percentage of the employee's average compensation, depending upon the type of defined benefit plan selected by the employer. The three most commonly used defined benefit plans are the flat benefit plan, the unit benefit plan and the variable benefit plan. A flat benefit plan provides a retirement benefit in the form of a percentage of the employee's average annual compensation at retirement.[8] In a unit benefit plan, the retirement benefits are weighted by the number of years of service that the employee worked for the company.[9] A variable benefit plan is designed to provide a fixed dollar benefit at retirement and also reflect the appreciation realized by the investment made by the pension trust.[10]

The employer who establishes a profit sharing plan makes fixed annual contributions on behalf of each employee, who, upon retirement, receives the sum of employer contributions plus any appreciation realized through the investment of those contributions. A profit sharing plan resembles the mechanics of the money purchase pension plan,[11] as in both plans the employer is making a fixed annual *contribution* and the employee participates proportionately in the investment performance of the trust. One major distinction between the

4. *Id.* §§ 402(a), 403(a).

5. *Id.* §§ 402(a)(2), 403(a)(2), *as amended,* Pub. L. No. 93-406, § 2005(a) (Sept. 2, 1974).

6. *Id.* § 2039(c).

7. Treas. Reg. § 1.401-1(b) (1956).

8. BERGMAN, 205-3rd T.M., PENSION, PROFIT-SHARING PLANS, ETC.—SELECTION [hereinafter cited as BERGMAN]. Employer contributions under a flat benefit plan must be determined actuarily since certain factors such as the employee's age and the growth rate of the fund will be determinative of exactly what amount of funds are necessary to provide that employee with a fixed pension for the remainder of his life.

9. *Id.*

10. *Id.*

11. *Id.*

profit sharing plan and the money purchase pension plan is that under the profit sharing plan the contributions may vary from year to year and must be made out of profits, whereas under the pension plan contributions must be made annually pursuant to a regular formula.[12]

II. What Is Meant by Integration

In order for a particular plan to be "qualified," it must meet certain rigorous requirements imposed by the Code.[13] A plan must not discriminate in favor of officers, shareholders, supervisors or highly compensated employees (the "prohibited group");[14] thus a plan which provides coverage for only members of the prohibited group would most likely be considered discriminatory.

A classification within a plan will not necessarily be discriminatory merely because it excludes employees earning below a certain compensation level or because the plan provides a higher rate of benefits or contributions on compensation above a certain level than it does on compensation below that level.[15] A plan including one of the classifications mentioned above will not be considered discriminatory if the differences in benefits of the private plan are approximately offset by the benefits provided by Social Security;[16] the private and Social Security benefits being considered as one total benefit. Thus, if the total employee benefit is not discriminatory in favor of employees earning above a certain salary amount, the private plan will be considered to be properly integrated with Social Security.

Any qualified pension or profit sharing plan can be integrated with Social Security. The benefits and contributions of the Social Security system constitute the first level of the total pension, and the private plan provides supplementary benefits or contributions at the point where Social Security leaves off. In effect, the employer is given a "credit" toward the contributions or benefits of his private plan for the Social Security taxes that he must pay for his employees, an advantage that can reduce the cost of the private plan approximately by the amount paid in Social Security taxes. Additionally, integration makes it possible for a small company to reward its higher paid employees by restricting benefits or contributions to employees whose earnings are in excess of a specified dollar amount which is referred to as the plan's *integration level.*

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12. *Id.* Contributions under a profit sharing plan are discretionary, however, they must be recurring and substantial. Treas. Reg. § 1.401-1(b)(2) (1956).

13. INT. REV. CODE OF 1954, § 401.

14. *Id.* § 401(a)(4).

15. *Id.* § 401(a)(5). The language of this Code section refers to a plan that "excludes employees the whole of whose remuneration constitutes 'wages' under section 3121(a)(1) (relating to the Federal Insurance Contribution Act) . . . ." This Act will be referred to for simplicity as the Social Security Act.

16. Treas. Reg. § 1.401-3(e)(1) (1956). The qualified plan is referred to as a private plan as distinguished from Social Security which is a public plan.

A. *Integration Rates*

Integration is accomplished by first ascertaining the allowable integration rate for the particular plan in use. The integration rate, stated as a percentage, is then multiplied by the employee's compensation in excess of the integration level to determine the allowable amount of contributions or benefits. It is therefore necessary to examine how to ascertain a plan's integration rate and to determine the plan's integration level.

The employer is required to pay Social Security taxes on employee wages up to a certain level of compensation.[17] When a private plan is properly integrated with Social Security, the rate of benefits or contributions provided by the private plan are no greater than those provided by Social Security. An integration rate is, therefore, the value of the Social Security benefits or contributions that are provided by the employer's share of Social Security taxes.

For a flat benefit plan, the Treasury Regulations currently apply a 37½% integration rate to compensation in excess of the plan's integration level to an employee who will have completed 15 years of service prior to retirement.[18] This rate represents the percentage of total Social Security benefits that the employer's share of the Social Security taxes will provide to his employees.[19]

Since the employer is already paying for 37½% of the costs of the Social Security benefit that the employee will receive at retirement, he is given a credit toward the benefits provided by the private plan for the benefits afforded by his portion of Social Security taxes. Consequently, the employer does not have to provide any benefits through the private plan on wages that are below the level of compensation on

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17. The employer must pay employment taxes under the Social Security Act at a rate of 4.95% up to $13,200 of every employee's salary. INT. REV. CODE OF 1954, §§ 3101, 3121.

18. Treas. Reg. § 1.401-3(e) (1956). If an employee will have less than 15 years of service, the percentage is reduced at a rate of 2½% per year. Treas. Reg. § 1.401-3(e)(2)(ii)(*f*).

19. The rate of 37½% is arrived at in the Regulations via a three-step process. First, a benefit rate of basic old age benefits is determined by averaging the benefit rates of a 65-year-old taxpayer retiring in 1971 with one retiring in 2010. An employee retiring in 1971 would receive a maximum possible benefit of $213.10 per month on covered compensation of $460 which equals a benefit rate of 46.30%. An employee retiring in 2010 could receive a maximum possible benefit of $295.50 per month on covered compensation of $750 per month which comes out to a benefit rate of 39.40%. The average of the two rates (46.30% and 39.40%) is 42.85%, which rounds off to 43%. Second, the present supplemental Social Security benefits are assumed to be 62% of the old age benefits. Therefore, the total old age, survivor and disability benefits with respect to an employee are considered to be 162% of the employee's old age insurance benefits. The total benefits of 162% would thus constitute 70% (162% × 43%) of the average monthly tax base. Third, since one-half of the Social Security contribution is paid by the employer, the basic integration rate is 35% (½ × 70%). In anticipation of future changes in the Social Security Act, this figure of 35% was raised to 37½%. This maximum rate of 37½% is available only under the conditions that no benefits are payable in case of death before retirement, the form of retirement benefit is a straight-life annuity and normal retirement age is no lower than 65 years of age. The employee is also required to complete 15 years of service with the employer. If any of these conditions are not present in the plan, then the 37½% rate must be reduced as will be discussed later in this article. Treas. Reg. § 1.401-3(e) (1956). For an excellent discussion of how the 37½% rate is arrived at, see J. CHOMMIE, FEDERAL INCOME TAXATION (2d ed. 1973).

which Social Security taxes must be paid; however, the employer is limited to a benefit rate of 37½% on compensation above that level. Hence, the integration rate attempts to make the benefit rate of the private plan equal to the benefit rate of Social Security.

In a money purchase plan, the maximum integration rate is 7% of compensation, this figure representing approximately the rate of Social Security taxes that the employer pays on his employee's wages.[20] An employer could therefore make contributions to a money purchase pension plan at a rate of 7% of compensation in excess of the plan's integration level while making no contributions on compensation below the integration level.

One can easily see that the plan's integration level is a crucial amount in an integrated plan because this is the level of compensation at which the employer must begin providing employees with benefits or contributions from the private plan.

B. *Integration Levels*

As has been stated earlier, the private plan and Social Security are considered together for purposes of integration as one plan providing a total employee benefit. A plan's integration level is an amount of compensation that separates the private plan from Social Security. Compensation below the integration level is excluded from the private plan because it is assumed that such compensation is covered by Social Security. But compensation above the integration level must be covered by the private plan because this is the level of compensation at which it is assumed that Social Security leaves off and the private plan takes over.

In a flat benefit plan, the employer is credited for the amount of Social Security benefit that his taxes will provide, thus allowing him to exclude from participation in the private plan that amount of employee compensation which is subject to Social Security taxes for the employee's entire working life.[21] The amount which may be excluded from participation in the private plan is known as *covered compensation.*[22] Put another way, covered compensation is an average of the maximum amounts of employee compensation that are "covered" by Social Security taxes for each year that the employee has already worked and for the years that he will continue to work until he reaches age 65. The amount of covered compensation therefore varies according to the age of the employee.

Since the amount of wages covered by Social Security taxes has risen steadily since the inception of the Social Security System, an

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20. Rev. Rul. 71-446 § 14, 1971-2 CUM. BULL. 187. Although under the current Social Security Act the employer must contribute 4.95% of the employee's salary up to a certain level, the Treasury made allowances for increases in this rate.

21. *Id.* §§ 2, 5.

22. *Id.* § 2.

employee who has reached 65 years of age in 1974 will, if this trend continues, have a lower covered compensation than an employee who will retire in the year 2010. One does not have to calculate covered compensation because the Treasury has designed tables which supply the amount of covered compensation according to the year of a person's 65th birthday.[23]

The integration level in a flat benefit plan cannot exceed the covered compensation of any individual who is now or who may become a participant in the plan.[24] The reason for using covered compensation as a ceiling is that the integration level of a plan is assumed to be the maximum amount of compensation on which Social Security taxes will be paid. If the integration level were greater than covered compensation, a segment of compensation between the two

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23. Rev. Rul. 71-446, 1971-2 CUM. BULL. 187.

TABLE I

Calendar year of 65th birthday:	Amount
1971	$5,400
1972 to 1975	6,000
1976 to 1981	6,600
1982 to 1991	7,200
1992 to 1998	7,800
1999 to 2003	8,400
2004 or later	9,000

TABLE II

Calendar year of 65th birthday:	Amount
1971	$5,520
1972	5,652
1973	5,856
1974	6,024
1975	6,180
1976	6,324
1977	6,456
1978	6,564
1979	6,672
1980	6,768
1981	6,864
1982	6,936
1983	7,020
1984	7,092
1985	7,152
1986	7,212

TABLE II—continued

Calendar year of 65th birthday:	Amount
1987	$7,272
1988	7,320
1989	7,380
1990	7,428
1991	7,464
1992	7,512
1993	7,548
1994	7,584
1995	7,716
1996	7,836
1997	7,968
1998	8,076
1999	8,184
2000	8,304
2001	8,412
2002	8,520
2003	8,628
2004	8,736
2005	8,808
2006	8,868
2007	8,904
2008	8,928
2009	8,964
2010 or later	9,000

Table I reflects uniform rounding to $600 multiples and Table II reflects exact amounts of covered compensation. Either Table may be used but once a particular Table is selected it must apply to all employees uniformly.

24. *Id.* § 5. The requirement that the integration level not exceed the covered compensation of "any individual who is now or may become a participant" can best be explained by the following example. In July of 1975 the XYZ Corporation establishes a plan covering all employees hired before they have reached 60 years of age. The oldest employee presently employed by the company is 50 years old. Since it is possible that the company may hire a 60 year old employee who would participate in the plan, the maximum integration level of the plan must not exceed the covered compensation of a hypothetical employee who is 60 years old. At the date this plan was adopted a 60 year old employee would become 65 years of age in the year 1980. Therefore the maximum integration that can be used by this plan is determined from the tables on covered compensation to be $6,768. See note 23 *supra*.

amounts would be excluded from both Social Security and the private plan. The result would be that Social Security would not sufficiently offset the differences in benefits or contributions resulting from the exclusion from the plan of compensation below the integration level, thus making the plan discriminatory.

In drafting a flat benefit plan, it is wise to give an open-ended definition of covered compensation such as "the maximum amount of earnings that may be taken into account in computing a participant's Social Security benefits,"[25] as such a definition will avoid the necessity of amending the plan every time the Treasury updates the tables on covered compensation.

The maximum integration level for a money purchase plan is the Social Security taxable wage base for that year, *i.e.*, the amount of compensation on which the employer must pay Social Security taxes.[26] Since a money purchase plan requires annual contributions to an employee's retirement fund based upon compensation, the employer may therefore exclude from the plan that amount of compensation on which he has already paid Social Security taxes. The taxable wage base is considered to be an amount of compensation already covered by Social Security; therefore the private plan can begin making contributions based on compensation beyond that level.

C. *Increasing the Maximum Integration Levels*

The integration levels for the various qualified plans may be increased beyond the maximums described above by proportionately reducing the applicable integration rate.[27] This may be advantageous to the employer who wants to exclude a group of employees from participation in the private plan but whose employees have compensation in excess of the maximum integration level for that plan. By increasing the integration level, the employer may accomplish his objective of excluding certain employees from the plan, but to do this he must reduce the integration rate for the employees who are included in the plan. The employer must weigh the effects of the trade-off by comparing the amount which will be saved in excluding certain employees with the amount by which the benefits for the participating employees will be reduced.

For a flat benefit plan, an integration level higher than covered compensation may be used by proportionately reducing the maximum integration rate of 37½%. The following formula will be helpful in adjusting the integration rate to compensate for the higher integration level:

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25. See P-H PENSION & PROFIT SHARING ¶ 4066.

26. As of this writing, the Treasury was still using $9,000 as the amount of "wages" under section 3121(a)(1) and under Rev. Rul. 71-446 § 14, 1971-2 CUM. BULL. 187. This amount of $9,000 was the maximum amount of wages upon which an employee would pay an F.I.C.A. tax when the Social Security Act was amended through June 30, 1971.

27. Rev. Rul. 71-446 § 5, 1971-2 CUM. BULL. 187.

$$\text{Benefit rate} = 37\tfrac{1}{2}\% \times \frac{\text{Covered Compensation}}{\text{Desired Integration Level}}$$

Hence, a plan may be established in which the lowest covered compensation of any employee is $7,200. This plan would normally be limited to a maximum integration level of $7,200 and a maximum integration rate of 37½%. In such a plan the integration level may be increased to, say, $9,000, so long as the maximum integration rate is reduced to 30% ($7,200 / $9,000 × 37½%) of a participant's compensation in excess of $9,000.

The integration level for other qualified plans can be increased in much the same way by multiplying the applicable integration rate by the fraction: maximum allowable integration level over desired integration level.

After the type of qualified plan has been selected, the employer must next consider the particular method of integration that will produce his desired objective. Two basic types of integration plans have evolved: the *excess plan,* under which employee compensation below the amount covered by Social Security is excluded from the private plan; and the *offset plan,* under which no employees are excluded from the plan, but in which the plan's benefits are offset or reduced by a percentage of the Social Security benefits that the employee will receive.[28]

III. THE EXCESS PLANS

A. *The Flat Benefit Plan*

The excess plan is widely used and may be adapted to either a defined benefit plan or a money purchase plan. Essentially, the excess plan provides benefits or contributions to employees whose compensation is in excess of the plan's integration level. In a flat benefit excess plan, retirement benefits are provided at a rate of 37½% of average annual compensation in excess of the plan's integration level.[29] In this regard, an employee's average annual compensation is his annual compensation averaged over at least five years.[30] For purposes of figuring average annual compensation, it is acceptable to use any period of five consecutive years which will produce the highest average for a particular employee.[31]

As mentioned earlier, the integration level for a flat benefit plan cannot exceed the covered compensation of any employee who is now

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28. J. CHOMMIE, FEDERAL INCOME TAXATION § 97 (2d ed. 1973).
29. Rev. Rul. 71-446 § 5, 1971-2 CUM. BULL. 187.
30. *Id.* § 2. A plan may provide that an employee's average annual compensation be averaged over three or four years, but the 37½% integration rate would have to be reduced to 95% of the rate (35.625%) if 4 years is used and 90% of 37½% (33.75%) if 3 years is used. Rev. Rul. 72-276, 1972-2 CUM. BULL. 111.
31. Rev. Rul. 71-446 § 3, 1971-2 CUM. BULL. 187.

or who may become a participant in the plan.[32] A flat benefit excess plan will remain within this limitation by either using the covered compensation of each employee, thereby creating a separate integration level for everyone in the plan, or by adopting a uniform integration level.[33] Although the uniform integration level is used more frequently as a result of its simplicity, if a few employees have very low amounts of covered compensation while the majority of employees have rather high amounts, it would be advisable to use a separate integration level for each employee. In the situation just described, a uniform integration level would be more costly because the plan would have to integrate at a low level and begin to provide benefits at that level, to accommodate the few employees with low amounts of covered compensation.

The mechanics of the flat benefit excess plan can best be explained by the following example. In September of 1974 the XYZ Corporation establishes a flat benefit excess plan for its four employees. The plan has an integration level of $7,200 and it will provide an employee who retires after 15 years of service with an annual retirement benefit of 37½% of his average annual compensation in excess of the integration level. Employee *A* will receive no retirement benefit under this plan because his average annual compensation is not in excess of the integration level of $7,200. Employees *B*, *C* and *D* receive a retirement benefit equal to 37½% of the amount by which their average annual compensation exceeds the integration level of $7,200. Note that the plan is properly integrated as a result of the integration level of $7,200 not being greater than the covered compensation of any of the participants of the plan.

TABLE I

Employee	Age	Calendar Year of 65th Birthday	Covered[34] Compensation	(a) Integration[35] Level	(b) Average[36] Annual Compensation	Annual Benefit at Retirement ((b − a) × 37½%)
A	32	2007	$8,904	$7,200	$6,000	—0—
B	37	2002	$8,520	$7,200	$10,000	$1,050
C	46	1993	$7,548	$7,200	$15,000	$2,925
D	52	1987	$7,272	$7,200	$20,000	$4,800

The flat benefit excess plan is useful from a cost standpoint to the employer who has a great number of employees whose annual com-

32. *Id.* § 5.

33. *Id.*

34. See Table II at note 23 *supra*.

35. The integration level of $7,200 was selected because it does not exceed the covered compensation of any of the employees in the plan. Employee *D* has the lowest covered compensation level.

36. The average annual compensation of each employee was selected with no particular significance to any amount other than to have some employees with average annual compensation in excess of the integration level and others below the integration level.

pensation would be below the acceptable integration level for the plan. Such an employer would have the benefit of providing a private pension plan for the select group of employees who have compensation in excess of the integration level. It is important to be aware that if a plan is properly integrated it will not be considered discriminatory even though the only persons deriving a direct benefit from the plan are among the prohibited group.[37] Although the employees who are not members of the prohibited group do not have compensation in excess of the integration level and are not currently being benefited by the plan, they are nevertheless considered participants in the plan.[38] However, for purposes of employee morale, a plan which does not provide any benefits to a vast number of employees may not be wise and in such cases a step rate excess plan may be useful.

B. *Step Rate Excess Plan*

A step rate excess plan is one which provides benefits or contributions both above and below the plan's integration level at different integration rates.[39] This plan may be adapted to either a flat benefit plan or a money purchase plan. In essence, the step rate excess plan does not exclude anyone from receiving benefits from the private part of the plan.[40] As distinguished from the flat benefit excess plan described above, the step rate excess plan provides a benefit in addition to Social Security to employees whose average annual compensation is less than the plan's integration level.

The Treasury treats the step rate excess plan as two separate plans.[41] The benefit rate that applies to compensation below the integration level is considered to be part of one plan which applies to all compensation and all employees. The benefit rate that applies to compensation in excess of the integration level is considered to be part of another plan providing additional benefits on compensation in excess of the integration level. By subtracting the two benefit rates, one may determine whether the rates are properly integrated.[42] For example, a flat benefit excess plan may provide normal retirement benefits equal to 10% of compensation below the integration level and 47½% of compensation above the integration level (note the difference in percentages of 37½%). This plan has the effect of providing a 10% retirement benefit on *all* compensation and a 37½% retirement benefit

37. This situation is distinguished from a "salaried only" classification of employees which permits the plan to cover only those employees who are on a salary and excludes from the plan those employees who are paid an hourly wage. Such a classification is permissible so long as it does not result in preferential treatment for the prohibited group. INT. REV. CODE OF 1954, § 401(a)(5).

38. *Id.*

39. Rev. Rul. 71-446 § 16, 1971-2 CUM. BULL. 187.

40. *Id.*

41. *Id.*

42. *Id.*

on compensation *in excess* of the plan's integration level.[43] The benefit rate on compensation below the integration level must therefore be compared with the benefit rate on compensation above the integration level, and, if the difference does not exceed 37½%, the plan is properly integrated.

C. *Excess Plan with Two Integration Levels*

Another variation of the flat benefit excess plan is the excess plan with two integration levels. Such a plan will be properly integrated if the benefit rates (or employer contribution rates) applicable at each integration level do not exceed the maximum integration rate of 37½% that is applicable to plans with one integration level.[44] For example, a flat benefit excess plan may provide normal annual retirement benefits equal to 25% of an employee's average annual salary in excess of $2000 but not in excess of $5400, plus 37½% of average annual compensation in excess of $5400. Such a plan is integrated because neither of the benefit rates exceed the maximum of 37½%.[45] There may, however, be situations in which a flat benefit excess plan with two integration levels does not satisfy the basic 37½% limitation. Such a plan may qualify under an alternative method which is outlined in Revenue Ruling 71-446.[46] The excess plan with two integration levels is useful to the employer for the purpose of providing a greater benefit for his

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43. *Id.*

44. *Id.* § 19.

45. *Id.*

46. *Id.* The limitation on the flat benefit excess plan can be worked out under the formula below. This is to be used when the basic integration rates exceed 37½%.

Form of benefits	*Constant*
Flat benefit excess plan	$660.00
Unit benefit excess plan basing benefits on actual compensation	24.64
Unit benefit excess plan basing benefits on average annual compensation	17.60
Money-purchase, profit-sharing, or stock bonus plan	123.20

Example. A flat benefit excess plan without employee contributions provides normal annual retirement benefits upon retirement at age 65 with at least 15 years of service equal to 37½% of average annual compensation in excess of $4,800 but not in excess of $9,000, plus 39⅓% of average annual compensation in excess of $9,000. The earliest year in which any present or potential future participant can retire and receive benefits is 1972. Such plan is integrated; this is determined as follows:

1. Rate of benefit applicable to compensation between $4,800 and $9,000 does not exceed 37½%.

2. Rate of benefit applicable to compensation in excess of $9,000 does not exceed 39⅓%:

(a)	Plan's lower integration level	$4,800
(b)	Plan's higher integration level	$9,000
(c)	Maximum integration level for the year 1972	$6,000
(d)	"Constant" for the form of benefit, divided by (a): $660 ÷ $4,800	13.75%
(e)	Lesser of (d) and benefit rate actually provided (37½%) between (a) and (c)	13.75%
(f)	Assumed benefit provided between (a) and (c): 13.75% × ($6,000 − $4,800)	$ 105
(g)	Benefit actually provided between (c) and (b): 37½% × ($9,000 − $6,000)	$1,125
(h)	Total: (f) + (g)	$1,290
(i)	(h) ÷ (b)	14⅔%
(j)	37½% × (c) ÷ (b)	25%
(k)	Total limitation applicable to compensation in excess of (b): (i) + (j)	39⅓%

highly compensated employees than would be provided under an ordinary flat benefit excess plan, while simultaneously costing not quite as much as a step rate excess plan.

D. *The Unit Benefit Plan*

As explained previously, the unit benefit plan is a variation of the flat defined benefit plan in which the employees are provided with a fixed retirement benefit based upon a percentage of compensation.[47] This percentage is determined by multiplying the number of years an employee has worked for the company times a fixed benefit rate. For example, a plan that credits employees 1% for each year of service would provide a pension equal to 15% of actual compensation (or average annual compensation) in excess of the integration level to an employee who retires with 15 years service.

There are two basic methods of integrating a unit benefit excess plan. One way is to have the benefit rate apply to actual compensation. Such a plan is called a *career average plan* and the maximum rate at which the normal retirement benefit can be provided is 1.4% of compensation in excess of the integration level for each year of service.[48] The other basic method of integrating a unit benefit excess plan is called a *final average plan*.[49] This plan bases the retirement benefit on the employee's "average annual compensation."[50] In a final average plan, the maximum integration rate is 1% for each year of service.[51]

Since the final average plan is based upon average annual compensation, the integration rate is 40% (.4% ÷ 1%) lower than the integration rate for the career average plan which bases benefits on the employee's average compensation for his working life. Use of the final average plan would result in a greater pension during a period of double-digit inflation, since the employee's pension will be based upon his average highest level of compensation rather than on an average compensation for all the years that he has been employed, which will most likely be much lower.

The maximum allowable integration level for a unit benefit excess plan is dependent upon whether the plan is to have a fixed integration level or one that varies from year to year.[52] If the integration level is to

47. P-H PENSION AND PROFIT SHARING ¶ 4068.

48. *Id.*

49. *Id.*

50. The term "average annual compensation" has been used previously in conjunction with a flat benefit excess plan. It is the annual compensation of an employee averaged over five (5) consecutive years. See note 30 *supra*; Rev. Rul. 71-446 § 3, 1971-2 CUM. BULL. 187.

51. P-H PENSION AND PROFIT SHARING ¶ 4068.

52. The basic integration level for a unit benefit excess plan must be one of the following alternatives: (1) each employee's "covered compensation" or a uniform dollar amount that is applicable to all employees which is not greater than the covered compensation for any present or potential participant in the plan; (2) the Social Security taxable wage base for any one year or a lesser dollar amount; or (3) for years of service prior to a particular date specified in the plan, but

be a fixed level applicable to all years of service, then the maximum amount cannot exceed the covered compensation of any employee who is now or who may become a participant.[53] If the integration level is to vary from year to year, the maximum amount cannot exceed the Social Security taxable wage base for that year.[54] A plan may contain an integration level that is greater than the allowable integration levels discussed earlier by proportionately reducing the unit benefit rate.[55] For example, if a unit benefit excess plan is using an integration level of $10,000 and provides a 1% benefit rate in excess of the integration level for every year of service, the 1% benefit rate would have to be reduced to .5% even though the maximum allowable integration level was only $5,000 ($5,000/$10,000 × 1% = .5%).

The unit benefit excess plan, as contrasted with the flat benefit excess plan or the step rate excess plan, provides benefits "slowly" over a long period of time. Thus, a unit benefit excess plan would provide a relatively small benefit to the employee who has very few working years left to accrue service time. Additionally, the unit benefit plan makes it desirable for the employer to hire older employees since the older employee will only be able to give a few years of service to the employer and, therefore, receive a lower pension based upon the product of years of service and the unit benefit rate. In contrast, the use of a flat benefit excess plan would give such an employee while only having worked a few years a fixed benefit pension of 37½% of his average annual compensation.

E. *The Money Purchase Plan*

As defined earlier, the money purchase pension plan is one that makes contributions to a pension trust on behalf of an employee equal to a fixed percentage of current compensation.[56] The retirement benefit from the plan is the total dollar amount held by the trust when the employee retires. This total dollar amount will consist of employer contributions plus any income or gains received by the trust through investments.

The maximum integration rate for a money purchase plan is 7% of actual compensation in excess of the plan's integration level.[57] A

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a date no later than the end of the year in which the plan is established, the integration level shall be no greater than the Social Security taxable wage base. A plan may contain an integration level that is greater than the allowable integration levels discussed *supra* by proportionately reducing the unit benefit rate. Rev. Rul. 71-446 § 6, 1971-2 CUM. BULL. 187.

53. *Id.*

54. *Id.*

55. See section II, C *supra*.

56. BERGMAN, *supra* note 8.

57. Revenue Ruling 71-446 § 14 states that a money purchase plan may have an integration level equal to the amount allowed under a unit benefit plan (see note 52 *supra*). But, since the taxable wage base under Social Security will always be higher than covered compensation, it is usually considered that the maximum integration level for a money purchase plan is the taxable wage base under Social Security. BERGMAN, *supra* note 8.

money purchase plan may be integrated at a level of compensation no greater than the taxable wage base for Social Security for that year.[58] Therefore, any amount of employee compensation that is less than the taxable wage base for Social Security for that year may be excluded from the private plan since that amount is already being covered by Social Security.[59]

The money purchase plan can be best explained through the following example. The ABC Corporation decides to adopt a money purchase plan for its four employees. The company must pay Social Security taxes on all employee compensation at a rate of 4.95% up to $13,200.[60] Employees *A* and *B* receive no contributions under the private plan because their annual salaries are not in excess of the $9000 integration level. Thus, the newly adopted pension plan will cost the corporation nothing with respect to those two employees. Employees *C* and *D* will have contributions made on their behalf equal to 7% of their current compensation in excess of $9,000. Thus, the private plan is only benefitting employees *C* and *D*.

TABLE II

Employee	(a) Annual Salary	(b) Integration[61] Level	Social Security[62]	Private Plan (a − b) × 7%	Total Contributions
A	$ 7,000	$9,000	$346.50	0	$ 346.50
B	$ 9,000	$9,000	$445.50	0	$ 445.50
C	$13,200	$9,000	$653.40	$248	$ 937.40
D	$15,000	$9,000	$653.40	$420	$1073.40

In practice, the money purchase plan is most beneficial to the young employee who can give many years of service to a company, since the longer he works for that company, the more contributions the pension trust will receive in his behalf. In contrast, flat benefit excess plans can provide an annual retirement benefit up to 37½% of average annual compensation to employees who have worked for the company for a relatively short time.[63] Therefore, an employer whose objective is to provide a retirement benefit for a group of older employees would be best suited by using a flat benefit excess plan as opposed to a money purchase plan.

58. Rev. Rul. 71-446 § 14, 1971-2 CUM. BULL. 187.

59. *Id.* § 2.

60. INT. REV. CODE OF 1954, §§ 3121(a)(1), 3101. As of this writing the Treasury was still using $9,000 as the amount of "wages" under section 3121(a)(1) of the Internal Revenue Code and under Rev. Rul. 71-446.

61. An integration level of $9,000 is used because this amount was the maximum amount of wages upon which an employee would pay an F.I.C.A. tax when the Social Security Act was amended through June 30, 1971. BERGMAN, *supra* note 8.

62. The amount of Social Security taxes that the employer must pay is arrived at by multiplying 4.95% times the employee's compensation up to $13,200. INT. REV. CODE OF 1954, §§ 3121, 3201.

63. Rev. Rul. 71-446 § 5, 1971-2 CUM. BULL. 187. See section III, A *supra*.

As mentioned earlier, the profit sharing plan for purposes of integration with Social Security is practically identical to the money purchase pension plan and, therefore, the same limitations as to integration levels and integration rates apply to a profit sharing plan as apply to a money purchase plan.[64]

F. *Variable Benefit Plans*

Unlike an employee in a money purchase pension plan or the profit sharing plan, a flat benefit excess plan employee does not participate directly in the income appreciation within the pension trust. For this reason, the variable benefit pension plan was created and is designed to provide an employee with a flat benefit at retirement plus a participation in the tax-free investment performance of the pension trust.[65] This plan is an advisable alternative to the employer who wants to protect his employee's benefits from erosion due to inflation but at the same time does not want to adopt a money purchase plan which would penalize older employees who would receive only a few years of contributions for their pensions. Such a plan may be integrated with Social Security so long as the total benefit does not exceed the permissible integration rates for that particular plan.[66] For example, a flat benefit excess plan may provide for: (1) a benefit rate of 35% of average annual compensation in excess of the plan's integration level; and (2) an allocation among the participants of the income from the trust in excess of an assumed interest rate. The income from the earnings of the pension trust equals 2% of total compensation. As a result, if the total benefit rate including the income from the trust is 37% of annual compensation, the plan is properly integrated, as the total benefit rate of 37% does not exceed the maximum allowable benefit rate of 37½%.[67] Hence, a flat benefit excess plan must provide limitations to prevent benefits payable at retirement from exceeding 37½%. If the total benefit rate of the plan exceeds the maximum allowable integration rate because of the variable feature, an adjustment must be made to reduce the benefit rate.[68]

IV. THE OFFSET PLAN

In contrast to the excess plan, the other basic integration plan, called the offset plan, is one that does not exclude employees whose

64. Rev. Rul. 71-446 § 15, 1971-2 CUM. BULL. 187.

65. BERGMAN, *supra* note 8.

66. Rev. Rul. 71-446 § 18, 1971-2 CUM. BULL. 187.

67. *Id.* § 5. The example is a variable benefit plan using the flat benefit excess method. If a unit benefit plan based on actual compensation is used, the variable benefit pension can be integrated if the assumed rate of interest above which the income will be distributed to the participants is at least 5½%. For example, if the assumed rate is less than 5½%, the maximum benefit rate of 1.4% must be reduced by 1/15 for each ½% that the assumed rate is less than 5½%.

68. BERGMAN, *supra* note 8.

compensation is below a certain minimum level.[69] Under an offset plan, no portion of compensation is excluded in the computation of benefits and all of the provisions of the plan apply to all employees uniformly, without regard to a participant's compensation level.[70] Employee benefits under an offset plan are computed under a plan formula and then reduced or "offset" by a stated percentage of the employee's Social Security benefits.[71] For example, a plan may provide for pension benefits at retirement equal to 50% of an employee's salary, offset by 40% of the employee's primary Social Security benefits. If the employee has a salary of $2,000 per month and his Social Security benefits are $200 per month, then his net monthly benefit from the private plan will be $920 per month (50% of $2,000 = $1,000, less 40% of $200).

An offset plan is properly integrated with Social Security if the amount of the offset does not exceed 83⅓% of the employee's Social Security benefit.[72] The 83⅓% offset rate is computed on the benefits from the Social Security Act in effect at the time the employee retires.[73] However, the dollar amount of the offset as computed at retirement may not be increased due to subsequent increases in the Social Security Act.[74] If the plan is based upon earlier Social Security Acts, the following maximum offset percentages apply: 1969 Act – 92% of Social Security old age benefits; 1967 Act – 105% of Social Security old age benefits; and 1965 or 1958 Acts – 117% of Social Security old age benefits.[75]

The offset plan is grossly unfair to employees since any increase in Social Security benefits prior to an employee's retirement only works to reduce his potential benefits under the private plan. This situation gives the employer more than his deserved "credit" for Social Security payments and may entirely deprive employees of any benefits at all under a private plan. For this reason it is submitted that the offset plan be eliminated as a method of integration.

V. Adjustments to the Integration Rates

As mentioned previously, the integration rates for the various qualified plans are designed to equalize the rate of benefits of the private plan with the rate of benefits provided by Social Security.[76] If

69. Rev. Rul. 71-446 § 7, 1971-2 Cum. Bull. 187.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* The Pension Reform Act codifies this practice of reducing private plan payments due to increases in Social Security benefits, and, in addition, prohibits a reduction of private plan benefits because of an increase in Social Security benefits where the employee was separated from the employer's service prior to normal retirement and has nonforfeitable rights to benefits. Pub. L. No. 93-406 1021(e) (Sept. 12, 1975).

75. *Id.*

76. See section II, A *supra*.

there are benefits provided through the private plan that are not provided by Social Security, the integration rate for that particular plan must be adjusted to reflect the existence of additional benefits. These additional benefits and the respective adjustments to the integration rates are the subject of the following discussion.

A. *Pre-Retirement Death Benefits*

A qualified plan may provide incidental pre-retirement death benefits in addition to the contributions or benefits otherwise provided by the plan.[77] Since Social Security does not provide for a pre-retirement death benefit, the integration rate must be reduced accordingly.[78]

The pre-retirement death benefit may take the form of a lump-sum payment or a straight-life annuity to the spouse.[79] For a lump-sum payment, the amount of the death benefit may be either the total amount of prior contributions made for the deceased employee through the plan or a maximum of 100 times the deceased employee's anticipated monthly retirement benefit.[80] Of these two amounts, the larger figure will usually be 100 times the anticipated monthly retirement benefit, and therefore the integration rate of a plan containing such a provision would have to be reduced more than a plan that provided a death benefit equal to the total prior contributions.[81] If the pre-retirement death benefit takes the form of a straight-life annuity to the employee's spouse equal to a percentage of the employee's accrued retirement benefit, the integration rate must be reduced according to what percentage of the accrued benefit the spouse will receive.[82] The

77. BERGMAN, *supra* note 8.

78. Rev. Rul. 71-446 § 8, 1971-2 CUM. BULL. 187.

79. *Id.*

80. An integrated plan may provide a lump-sum pre-retirement death benefit which is not in excess of the greater of the reserve or total prior contributions on a typical individual level annual premium funding method, provided that the plan includes no other death benefit or life insurance unless the cost of such benefits would be taxable to the employee. However, the integration rate for such a plan must not exceed 8/9 of the maximum integration level otherwise applicable to that particular plan. For example, if a flat benefit excess plan provided a pre-retirement death benefit, the maximum integration rate of 37½% would have to be reduced to 33⅓% (8/9 × 37½%). However, depending upon the terms of the pre-retirement death benefit, other fractions may be used to reduce the integration rate. If the pre-retirement death benefit equals 100 times the employee's anticipated monthly pension that he expects to receive on retirement and no part of such current cost of such death benefit is taxable to the employee, then the integration rate must be reduced to 8/10 of the otherwise applicable rate. If the plan offers a pre-retirement death benefit equal to 100 times the employee's anticipated monthly pension or the reserve on a typical individual level annual premium funding method and no portion of the current cost of such death benefit is taxable to the employee, then the integration rate must be reduced to 7/9 of the otherwise applicable rates. Rev. Rul. 71-446 § 8, 1971-2 CUM. BULL. 187.

81. *Id.*

82. A plan that provides the spouse with a straight life annuity is integrated if the benefits do not exceed a fraction equal to 7 divided by the quantity of 7 plus 2 times the percentage of accrued benefit to be received by the spouse. For example, a flat benefit plan provides a normal annual retirement benefit equal to 30% of average annual compensation in excess of the plan's integration level. If the employee dies before retirement, his widow will receive a life annuity

reduction in the integration rate will be greatest when the spouse takes 100% of the accrued benefit.[83] The lower the percentage of accrued benefit that the spouse receives, the less the integration rate has to be reduced to reflect the additional benefit.

B. *A Plan Providing Benefits in a Form Other Than a Straight-Life Annuity*

A plan may provide any one of a number of methods by which the normal retirement benefit may be paid to employees. Since Social Security benefits are paid in the form of a straight-life annuity, any other more favorable form of payment used by the private plan requires an adjustment to the basic integration rate to reflect the better terms.[84] For example, an annuity for ten years certain and life thereafter is more favorable than a straight-life annuity since the first ten years of payment are guaranteed whether the annuitant lives or not. In such a case the basic integration would have to be reduced to 90% of the allowable rate to reflect this additional benefit.[85]

C. *Early Retirement*

A qualified plan may provide for the payment of benefits due to retirement or any other severance from employment prior to the employee reaching age 65.[86] Since Social Security does not provide for early retirement, such a provision in a private plan would, in effect, be granting greater benefits under the private plan than are offered by Social Security.[87] Thus, the integration rate for the particular plan in use must be reduced to reflect this additional benefit.[88]

The payment of early retirement benefits may be made immediately upon the employee's early retirement or it may be deferred until he reaches age 65. Obviously, the payment of the benefits

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equal to ½ of his accrued benefit. The plan will be integrated because the benefit rate of 30% does not exceed .328 (37½% × [7 ÷ (7 + 2[½])]). *Id.* § 8.

83. *Id.*

84. *Id.* § 9.

Form of Retirement Benefit	Percentage of Integration Rate
Annuity for 5 years certain and life thereafter	97
Annuity for 10 years certain and life thereafter	90
Annuity for 15 years certain and life thereafter	80
Annuity for 20 years certain and life thereafter	70
Life annuity with installment refund	90
Life annuity with cash refund	85
Life annuity with one-half continued to surviving spouse of employee	80

85. *Id.*

86. BERGMAN, *supra* note 8.

87. Rev. Rul. 71-446 §§ 10, 11, 1971-2 CUM. BULL. 187.

88. *Id.*

immediately upon early retirement is more beneficial than the deferred payment until age 65 and therefore would require a much greater reduction in the integration rate.[89]

D. *Disability Payments*

A qualified plan may provide for benefits to be paid to participants in the event that they become disabled.[90] Although Social Security provides for disability benefits, the integration rates for all qualified plans are based upon the assumption that no disability benefits are payable under the private plan.[91] The integration rate must therefore be reduced if the qualified plan includes disability benefits in addition to contributions or benefits otherwise provided.[92]

This reduction in the integration rate is an attempt at equalizing the rate of benefits under the private plan with those provided by Social Security. As a result of the necessity for making the two plans as nearly equal as possible in order for the qualified plan to be properly integrated, it is required that the disability benefits under the private plan be payable only at a time when the employee is eligible for and actually receives disability benefits under Social Security.[93]

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89. If the employee is entitled to a pension on early retirement but the actual payment of the benefits is not to be made until the employee reaches age 65, then the maximum benefit must be reduced by a proportion of the number of years actually worked compared to the number of years he would have worked had he remained employed until age 65. Thus, in a flat benefit plan, the maximum benefit rate cannot exceed the product of the fraction: years of actual service over years of service if the employee had worked until age 65. This fraction is then multiplied by the integration rate applicable to that particular plan. In an offset plan the adjustment for early retirement can be accomplished by multiplying the maximum offset rate by either one of the following amounts: (1) the Social Security benefit to which the employee would be entitled at age 65 if he did not receive "wages" subject to the Social Security tax after early retirement; or (2) the Social Security benefit to which the employee would be entitled at age 65 if he had continued to work.

90. BERGMAN, *supra* note 8.

91. Rev. Rul. 71-446 § 12, 1971-2 CUM. BULL. 187.

92. A plan providing disability benefits payable before age 65 will be integrated with Social Security if all of the following requirements are satisfied: (1) the amount of the disability benefit must not exceed the retirement benefit that the employee would have received had he continued to work to age 65, multiplied by the greater of 70% or the percentage that results from dividing the employee's actual years of service by the number of years the employee would have worked if he had worked to age 65; (2) disability benefits are payable under the plan only for a period of time that the employee is eligible for and actually receives disability benefits under the Social Security Act; and (3) the maximum integration rate applicable to the particular plan must be reduced to 90% of the rate that would have been otherwise allowable had the plan provided no disability benefits. The requirements mentioned above apply to the flat benefit plans as well as the unit benefit plans. In the case of an offset plan that provides disability benefits before age 65, the plan will be integrated if the offset to any employee's benefit after age 65 does not exceed 90% of the maximum rate otherwise applicable and if the offset to any employee's disability benefit does not exceed 64% of the employee's actual disability benefit under Social Security.

The adjustment to the maximum integration rates is only necessary when a plan provides disability benefits prior to an employee's reaching age 65. If the disability benefits provided are not in excess of the maximum benefit rate otherwise payable under the plan and they are not payable before the employee reaches age 65, then no adjustment is necessary. *Id.* § 12.

93. *Id.*

VI. CONCLUSION

While there is a tremendous variety of qualified pension and profit-sharing plans, there is a method of integrating each of those plans with Social Security. As has been shown, integration is a device by which the qualified plan can be tailored to meet the precise needs of the employer. By increasing or decreasing the integration level the employer is able to shift benefits from one group of employees to another. Integration can make a qualified plan a viable alternative for the employer by simply "crediting" him for the Social Security taxes that he pays for his employees. Too often the qualified plan is immediately disregarded because of a lack of understanding of integration.

The Employee Retirement Income Security for Employees Act was just recently signed into law. (Pension Reform Act of 1974).[94] A partial effect of this Act will be that the advantages of the qualified plan will be increased for both the employer and employee. With the growing importance of pensions it is essential that practitioners thoroughly understand integration and how it works so that they may inform their clients of the benefits of an integrated plan.

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94. Pub. L. No. 93-406 (Sept. 2, 1974).