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Via E-mail

Clayton Klenke
Executive Director
Commission on Government Forecasting and Accountability
703 Stratton Office Bldg.
Springfield, IL 62706

Re: Article 3 and 4 Pension Plans as They Relate to Social Security Replacement Plan Rules and Guidance for Comparability Testing (IRS Revenue Procedure 91-40)

Dear Clayton:

As requested, we are providing narrative and illustrative analysis regarding the Downstate Police and Firefighter Pension Funds established under Articles 3 and 4 of the Illinois Pension Code and our understanding of the rules related to Social Security replacement plans and guidance for comparability testing.

Summary Comments

Segal believes that, to-date and into the near future, the Article 3 and 4 Funds satisfy the requirements of a Social Security replacement plan and that employers and employees are properly exempt from FICA (Federal Insurance Contributions Act) taxes. It is conceivable that – due to the diverging nature of increases in the Social Security Wage Base and applicable salary cap for Tier 2 members – safe harbors (as outlined below) relative to the design of the Tier 2 benefit formula may not ultimately be satisfied. However, additional testing on an individual basis (which takes into consideration the earlier retirement eligibility relative to Social Security) will result in the Article 3 and 4 Funds continuing to satisfy the Social Security replacement plan requirements for a longer period.

Background

Employers and employees are generally required to pay FICA taxes on compensation earned in the United States. Employees of state or local governments are provided an exemption if the employee participates in a retirement system that provides benefits that are comparable (or better) than the benefits provided through the Old-Age portion of Social Security. The IRS has provided guidance on determining whether a system's benefits are comparable to Social Security in IRS Revenue Procedure 91-40, which includes three levels of testing:

- Safe harbor benefit provisions[1] – If the benefit provisions meet certain requirements, then the Plan qualifies under a safe harbor and no further testing is required.

[1] IRS Revenue Procedure 91-40, Sections 1 – 3

- Individual comparison to safe harbor formula[1] – If the Plan does not satisfy the safe harbor requirements, then individual testing can be performed to confirm that the accrued benefits for active members of an employer meet the minimum benefit requirements.
- Individual comparison to Social Security Primary Insurance Amount – IRS Treasury Regulation 31.3121(b)(7)-2(e)(2) permits employers to compare the retirement benefits accrued under the system by members to the estimated retirement benefits such members would receive from Social Security on an individual-by-individual basis. In cases where the Plan's benefit are greater, those members would continue to be exempt from FICA taxes.

Note that the sample safe harbor and individual comparison tests shown in this letter (as defined below for FICA purposes) are included for illustrative purposes only. It is our understanding that, ultimately, it is the responsibility of the individual employers to determine whether they qualify for exemption from FICA taxes. In addition, implications for benefits that are not deemed comparable to Social Security fall on employers and employees; not the retirement system in which employees participate.

FICA Exemption Testing

- The Tier 1 benefit formula satisfies a safe harbor under the applicable IRS regulations to qualify for exemption and, therefore, Tier 1 members are exempt from FICA taxes.
- The Tier 2 benefit formula currently satisfies a safe harbor under the applicable IRS regulations, but a certain element of the Tier 2 structure will likely cause the formula to ultimately fail to meet the safe harbor for certain employers at some point in the future. Exactly when this happens will be highly dependent upon the demographics of each employer. In situations when the Tier 2 benefit formula does not satisfy a safe harbor, individual testing will be required for those employers.

Safe Harbor – Tier 1 Article 3 and Article 4 Plans

IRS Revenue Procedure 91-40 (Rev. Proc. 91-40) outlines a set of safe harbor formulas that are deemed to meet the minimum retirement benefits that a retirement system must provide to all members for them to be exempt from FICA taxes. If the System does not meet the safe harbor requirements, Rev. Proc. 91-40 describes procedures for employers to determine whether retirement benefits under other formulas meet the minimum retirement benefit requirement.

The retirement benefit for Tier 1 is generally equal to 2.5% of final salary per year of service (up to 30 years) payable at age 50 with 20 years of service.

For a Plan that provides benefits using a salary-related formula, the safe harbor requires a life annuity payable no later than age 65 that is at least equal to a minimum required percentage of final average salary per year of service. The minimum required percentage varies based on the length of the averaging period used to determine the final average salary.

[1] IRS Revenue Procedure 91-40, Section 4

The table below summarizes the minimum required percentage of final average salary per year of service for applicable averaging periods.

Averaging Period	Minimum Required Percentage
0 - 36 months	1.50%
37 - 48 months	1.55%
49 - 60 months	1.60%
61 - 120 months	1.75%
Over 120 months	2.00%

Since the Tier 1 averaging period is one year (12 months) and unreduced benefits are payable as early as age 50, the applicable minimum percentage for Tier 1 members is 1.50%. Therefore, the safe harbor is satisfied and Tier 1 members are exempt from FICA taxes.

Safe Harbor – Tier 2 Article 3 and Article 4 Plans

The retirement benefit for Tier 2 is equal to 2.5% of final average salary per year of service (up to 30 years) payable at age 55 with 10 years of service. A cap limits compensation used in the calculation of final average salary.

Since the Tier 2 averaging period is four years (48 months), the applicable minimum percentage for Tier 2 members is 1.55%. And since unreduced benefits are payable as early as age 55, there is no adjustment required for retirement age. However, the 2.5% accrual rate must be adjusted for the salary cap since the definition of compensation excludes compensation below the Social Security Wage Base (SSWB). Pensionable earnings for Tier 2 members are limited to $106,800 in 2011 growing at the lesser of CPI-U or 3%.

For calendar year 2024, the Tier 2 pay limit is $138,094 and the corresponding SSWB is $168,600. The applicable minimum percentage must be adjusted by multiplying by the ratio of aggregate compensation limited to the SSWB to aggregate compensation limited to the Tier 2 salary cap. The ratio is calculated separately for each employer.

To illustrate how this adjustment affects the safe harbor calculation, consider the following examples:

Example 1 – Fire Protection District ABC employs 100 Tier 2 members in calendar year 2024; 25 members have salary of $168,000 and 75 members have salary of $80,000.

The applicable ratio is: $\frac{25*\$168,000+75*\$80,000}{25*\$138,094+75*\$80,000} = \frac{\$10,200,000}{\$9,452,350} = 107.910\%$

The minimum required percentage for Fire Protection District ABC is determined by multiplying 1.55%[1] by 107.910%, which results in an adjusted minimum required percentage of 1.673%.

[1] The applicable minimum percentage from Revenue Procedure 91-40, Section 1, for an averaging period of 48 months.

Since the Tier 2 accrual rate of 2.5% exceeds 1.673%, Fire Protection District ABC satisfies the safe harbor exemption for 2024.

Example 2 – Fire Protection District XYZ also employs 100 Tier 2 members in calendar year 2024, all of whom have salary in excess of $168,600; this represents the "worst-case" scenario (regarding meeting safe harbor thresholds) for any employer in 2024.

The applicable ratio is: $\frac{100*\$168,600}{100*\$138,094} = \frac{\$16,860,000}{\$13,809,400} = 122.091\%$

The minimum required percentage for Fire Protection District XYZ is determined by multiplying 1.55% by 122.091%, which results in an adjusted minimum required percentage of 1.892%. Since the Tier 2 accrual rate of 2.5% still exceeds 1.892%, Fire Protection District XYZ – even with all 100 members having salary in excess of the SSWB – also satisfies the safe harbor exemption for 2024.

Example 2 demonstrates that under current circumstances (with respect to the level of SSWB and Tier 2 salary cap), even employers with the most extreme demographics (i.e., all members with salary at or exceeding the SSWB) satisfy the safe harbor provisions of Rev. Proc. 91-40.

The feature within the Tier 2 benefit structure that creates a potential issue for satisfying the safe harbor provisions indefinitely is related to how the SSWB and Tier 2 salary cap increase over time at diverging rates. Over the past ten years, the SSWB has increased by 3.7% per year, on average (in line with increases in the National Average Wage), while the Tier 2 salary cap increase is limited to a maximum annual increase of 3% (per statute). **These diverging values could eventually create a ratio adjustment that causes employers to not meet the safe harbor at some point in the future.**

Example 3 – Fire Protection District XYZ employs 100 Tier 2 members in calendar year 2048 (**24 years in the future**), all of whom now have salary in excess of the projected SSWB. For illustrative purposes, assume that in 24 years, the SSWB has increased[1] from $168,600 to $403,225 and the Tier 2 salary cap[1] has increased from $138,094 to $249,774.

The applicable ratio would be: $\frac{100*\$403,225}{100*\$249,774} = \frac{\$40,322,500}{\$24,977,400} = 161.436\%$

The minimum required percentage for Fire Protection District XYZ is determined by multiplying 1.55% by 161.436%, which results in an adjusted minimum required percentage of 2.502%. Since the Tier 2 accrual rate of 2.5% is less than 2.502%, Fire Protection District XYZ would fail to satisfy the safe harbor exemption for 2048.

Example 4 – Fire Protection District ABC, with a mix of 25 members having salary in excess of the SSWB and 75 members below SSWB, is projected to take over 80 years to have an adjusted minimum required percentage that does not satisfy the safe harbor exemption.

[1] Assuming increases in the SSWB of 3.7% per year and increases in the Tier 2 salary cap of 2.5% per year.

The extreme examples above illustrate the variables that can cause employers to fail to satisfy the safe harbor provisions of Rev. Proc. 91-40. Less extreme illustrations would ultimately result in similar outcomes, but over an even longer time period. The inability to satisfy the safe harbor exemption in the next few decades is only evident when the demographics of a specific employer heavily favor individuals with salaries exceeding the SSWB.

For 2024, the current Tier 2 salary cap of $138,094 is 81.9% of the current SSWB of $168,600. If for every year in the future the Tier 2 salary cap were at least equal to 62% of the SSWB, plans under Article 3 and Article 4 would meet the safe harbor provisions.

In situations where the Rev. Proc. 91-40 safe harbor is not met, IRS Treasury Regulation Section 31.3121(b)(7)-2(e)[1] provides employers an option to test members on an individual basis. Specifically, Sec. 31.3121(b)(7)-2(e)(2)(ii) states "*…A defined benefit retirement system maintained by a State, political subdivision or instrumentality thereof meets the requirements of this paragraph (e)(2) with respect to an employee on a given day if and only if, on that day, the employee has an accrued benefit under the system that entitles the employee to an annual benefit commencing on or before his or her Social Security retirement age that is at least equal to the annual Primary Insurance Amount the employee would have under Social Security…*"

Based on benefit amounts, the value available under Social Security could exceed that accrued under Tier 2. However, a reasonable interpretation of these regulations may allow the earlier unreduced retirement age of the Tier 2 structure to be taken into consideration by evaluating actuarial present values as compared to actual dollar amounts. Since the Tier 2 benefit is available unreduced at age 55 while the Social Security PIA would not typically be available until age 67, a comparison of actuarial present values at each members' attained age would demonstrate that the overall value of the Tier 2 benefit would exceed the Social Security PIA. Based on this comparison, the employee and their employer would be exempt from FICA taxes for the year in question.

[1] See the appendix for the full text of Sec. 31.3121(b)(7)-2(e)(1) and (2)(i) and (ii).

Additional Comments

Segal is not a law firm and we cannot offer legal advice. The comments in this letter are based on our many years of consulting to employee benefit plans and our interpretations of applicable IRS and Treasury regulations and publications. Any user seeking a legal opinion should consult with appropriate legal counsel.

This analysis was prepared under the supervision of Matthew Strom. Matthew Strom is a member of the American Academy of Actuaries and meets the Qualification Standards for Actuaries Issuing Statements of Actuarial Opinion in the United States of the American Academy of Actuaries to render the actuarial opinion contained herein.

Please let us know if you have any questions.

Sincerely,

Matthew Strom
Senior Vice President & Consulting Actuary

Appendix

IRS Treasury Regulations Section 31.3121(b)(7)-2(e)(1) and (2)(i) and (ii):

(e) Definition of retirement system—(1) Requirement that system provide retirement-type benefits. For purposes of section 3121(b)(7)(F), a retirement system includes any pension, annuity, retirement or similar fund or system within the meaning of section 218 of the Social Security Act that is maintained by a State, political subdivision or instrumentality thereof to provide retirement benefits to its employees who are participants. Whether a plan is maintained to provide retirement benefits with respect to an employee is determined under the facts and circumstances of each case. For example, a plan providing only retiree health insurance or other deferred welfare benefits is not considered a retirement system for this purpose. The legal form of the system is generally not relevant. Thus, for example, a retirement system may include a plan described in section 401(a), an annuity plan or contract under section 403 or a plan described in section 457(b) or (f) of the Internal Revenue Code. In addition, the Social Security system is not a retirement system for purposes of section 3121(b)(7)(F) and this section.

(2) Requirement that system provide minimum level of benefits—(i) In general. A pension, annuity, retirement or similar fund or system is not a retirement system with respect to an employee unless it provides a retirement benefit to the employee that is comparable to the benefit provided under the Old-Age portion of the Old-Age, Survivor and Disability Insurance program of Social Security. Whether a retirement system meets this requirement is generally determined on an individual-by-individual basis. Thus, for example, a pension plan that is not a retirement system with respect to an employee may nevertheless be a retirement system with respect to other employees covered by the system.

(ii) Defined benefit retirement systems. A defined benefit retirement system maintained by a State, political subdivision or instrumentality thereof meets the requirements of this paragraph (e)(2) with respect to an employee on a given day if and only if, on that day, the employee has an accrued benefit under the system that entitles the employee to an annual benefit commencing on or before his or her Social Security retirement age that is at least equal to the annual Primary Insurance Amount the employee would have under Social Security. For this purpose, the Primary Insurance Amount an individual would have under Social Security is determined as it would be under the Social Security Act if the employee had been covered under Social Security for all periods of service with the State, political subdivision or instrumentality, had never performed service for any other employer, and had been fully insured within the meaning of section 214(a) of the Social Security Act, except that all periods of service with the State, political subdivision or instrumentality must be taken into account (i.e., without reduction for low-earning years).