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SOCIAL SECURITY OVERVIEW FOR PUBLIC EMPLOYERS

INTRODUCTION

Public employees participate in Social Security under complex rules that do not apply to workers in the private sector. The distinction stems from a historical constitutional concern about the federal government's authority to tax state and local governments and their employees. Social Security coverage is funded by a tax on the employee's wages, which is shared equally by the employee and the employer. Wages that are not covered by Social Security are not subject to the tax. Likewise, non-covered wages are not included in a worker's earnings record for purposes of calculating his or her Social Security benefit at retirement. Because there was originally a constitutional question regarding the application of Social Security taxes to state and local government employees, their wages are covered by Social Security today in only one of two ways: either the state has entered into a voluntary agreement with the Social Security Administration to cover certain positions of employment, or the employee is not earning a benefit through his or her employer's retirement plan that qualifies as a replacement to Social Security.

The relationship between public retirement systems and Social Security coverage can have a significant impact on plan design and funding, depending on the employer's desired coverage status for its employees—and a failure to recognize the interplay between public pensions and Social Security coverage can sometimes lead to unintended coverage results. This article provides an overview of the rules that govern Social Security coverage for public employers and identifies key points that both public employers, administrators of public pension systems, and state legislatures need to consider when implementing new coverage tiers or making other plan design changes.

This article is organized into three parts. Part I outlines the way in which public employees may be covered by Social Security.[1] Part II discusses the minimum requirements applicable to defined benefit plans and defined contribution plans in order for participants to be exempt from Social Security coverage (referred to in this article as "Social Security Replacement Plans").[2] Part III addresses recent federal law changes that eliminated two provisions that operated to potentially reduce a public employee's Social Security benefits based on a pension earned in non-covered employment. A timeline of relevant dates and governmental resources is included in Appendix A.

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[1] This article uses the term "public employees" to refer to employees of state and local governments. It is not intended to refer to employees of the federal government.

[2] In Social Security parlance, these plans are often referred to as "qualified replacement plans" or "FICA replacement plans." This article uses the term "Social Security Replacement Plans" to avoid any confusion with plans that are qualified under Internal Revenue Code Section 401(a). This article also avoids "FICA" references because employees covered by Social Security Replacement Plans are only exempt from the Social Security portion of FICA. Medicare coverage generally is mandatory for all public employees hired on or after April 1, 1986.

I. HOW SOCIAL SECURITY COVERAGE APPLIES TO A PUBLIC EMPLOYEE

A. Evolution of Social Security Coverage for Public Employees

As a preliminary matter, nearly all employees who work for employers in the private sector are covered by Social Security on a mandatory basis, meaning that the coverage is not elective by either the employer or the employee. Historically, however, wages earned by employees in service to state or local governments were excluded from Social Security, and public employees instead relied on the pension plans provided by their employer to plan for retirement.

Beginning in 1951, states were allowed to enter into voluntary agreements with the federal government to provide Social Security coverage to their employees, as well as employees of political subdivisions within the state. The agreements are called "Section 218 Agreements," named after the section of the Social Security Act that authorizes such arrangements. Every state has a Section 218 Agreement that covers positions in state and local government. Initially, a state could only extend Social Security coverage under a Section 218 Agreement to those employees of the state (or any political subdivision within the state) whose positions were not covered by a public retirement system. In other words, Social Security coverage was not available to public employees participating in a public retirement system.[3]

The Social Security Act was amended in 1955 to allow states the option of extending Social Security coverage to employees whose positions are covered by a public retirement system. For these individuals, however, coverage may only be extended as the result of a referendum conducted by the state in which eligible members of the system vote to be covered by Social Security. The referendum process is described in Part I.D. Initially, a state could modify its Section 218 Agreement with the Social Security Administration to terminate coverage by following termination procedures. Effective April 20, 1983, coverage that is extended to any position under a Section 218 Agreement (including coverage extended prior to April 20, 1983 that was then in effect) cannot be terminated, except in cases where an entity under the Section 218 Agreement legally dissolves.

Finally, in 1991, the law changed again, to provide that public employees are subject to Social Security coverage on a mandatory basis, similar to private sector employees, unless they are members of a Social Security Replacement Plan. This change provided a new protection to public employees by triggering application of mandatory Social Security coverage for any employee whose benefit under a public retirement system does not meet certain minimum requirements that qualify it to replace Social Security benefits. Note that although members of a Social Security Replacement Plan are not subject to mandatory Social Security coverage, their wages are still covered by Social Security if their position is covered by a Section 218 Agreement.

As a result of all these changes under the law, a public employee's coverage status will generally be one of the following:

— **The employee is subject to Social Security coverage** because he or she is not a member of a Social Security Replacement Plan.

[3] This was true regardless of the level of benefit offered by the public retirement system.

— **The employee is subject to Social Security coverage** because, regardless of whether he or she is a member of a Social Security Replacement Plan, he or she works in a position or provides a service that is covered by Social Security under a Section 218 Agreement.

— **The employee is not subject to Social Security coverage** because he or she is a member of a Social Security Replacement Plan, and he or she is not in a position that is covered by a Section 218 Agreement.

There is no difference between "mandatory" and "voluntary" Social Security coverage.

Social Security coverage that is provided under a Section 218 Agreement is sometimes referred to as "voluntary" coverage, both to distinguish it from mandatory Social Security coverage and to reflect that the Section 218 Agreement is a voluntary agreement between each state and the Social Security Administration. Whether a public employee is covered by Social Security by way of a Section 218 Agreement or by application of mandatory Social Security coverage does not impact how Social Security taxes are imposed or collected. The distinction is important only in the way the coverage rules interact with pension benefits. Voluntary coverage under a Section 218 Agreement is not affected by pension benefits, whereas, as discussed below, mandatory coverage is directly related to the employee's level of benefit.

B. Mandatory Social Security Coverage

Social Security coverage is now mandatory for public employees who are not members of a Social Security Replacement Plan and are not covered under a Section 218 Agreement. Social Security Replacement Plans are discussed in detail in Part II, but as a general description, a Social Security Replacement Plan is a retirement plan that provides a benefit that is at least as favorable to the employee as that employee would receive under Social Security. The mandatory Social Security provisions also apply to those employees who have the option to become members of a Social Security Replacement Plan, but choose not to do so, and those employees who are personally ineligible for membership in a Social Security Replacement Plan, although they are in positions that are covered under the plan. Mandatory Social Security coverage ceases for any public employee when that employee becomes a member of a Social Security Replacement Plan.

C. Section 218 Agreements

If a public employee's position is covered by a Section 218 Agreement, wages earned by the employee in that position are subject to Social Security as a result of the Agreement. A position can be covered under a Section 218 Agreement if it is part of an absolute coverage group or a retirement system coverage group.

— An "**absolute coverage group**" includes positions that were not covered by a public retirement system on the date the Section 218 Agreement (or applicable modification) became applicable to the group. The state may unilaterally elect to cover any positions that are not covered by a public retirement system as an absolute coverage group, without the consent of employees in those positions.

— A "**retirement system coverage group**" includes positions that are covered under a public retirement system, where the employees holding those positions have voted to have Social Security coverage through a referendum process. The state may only extend coverage under a Section 218 Agreement to retirement system coverage groups pursuant to the results of a referendum.

Generally, once a position is covered by a Section 218 Agreement as part of an absolute coverage group or a retirement system coverage group, an employee in such position will always be covered by Social Security, even if his or her position later comes under a public retirement system or is removed from a retirement system.[4] This is true even if the public retirement system meets the requirements of a Social Security Replacement Plan.

D. Coverage Referendums

A state may not unilaterally extend Social Security coverage under its Section 218 Agreement to any positions covered by a public retirement system. In this circumstance, a referendum is required. If the result of the referendum favors coverage, the state will modify its Section 218 Agreement with the Social Security Administration to include the positions held by members of the public retirement system, including the positions of all new members of the retirement system.[5] Once this occurs, coverage by way of a Section 218 Agreement cannot be terminated unless the entity under the Section 218 Agreement legally dissolves. The consequence of this fact is that, in the absence of legal dissolution, an entity covered by the Section 218 Agreement must cover all of its employees in positions covered by the Section 218 Agreement under Social Security, regardless of the level of pension benefit it provides to such employees.

All states may conduct a referendum process by majority vote, whereby the entire coverage group becomes covered by Social Security if a majority of eligible employees vote in favor of coverage. In addition, several states are authorized to conduct a referendum process by divided vote, whereby only the positions of members who vote in favor of coverage (and all new hires thereafter) become covered by Social Security. The positions of members who do not vote in favor of coverage remain exempt. This section provides an overview of both the "majority vote" and "divided vote" referendum process.

1. Majority vote referendum process

Employees in positions under a public retirement system in every state can be covered by Social Security through the process of a majority vote referendum. The referendum provides employees who are currently holding the positions under the retirement system the opportunity to vote to determine whether their services will be covered by Social Security. If the result of a majority vote referendum is in favor of coverage, then the state's Section 218 Agreement will be modified to cover all positions under the retirement system that participated in the referendum.

[4] There are some exceptions to this rule under the continuation of coverage rules that apply to Section 218 Agreements, which are outside the scope of this article.

[5] This referendum process and the resulting modification are subject to review and approval by the Social Security Administration.

The retirement system that participates in a referendum may be an entire public retirement system (*i.e.*, all participants of one of the state's public pension plans), or the referendum may be conducted for a subset of a public retirement system that is allowed to have a referendum under federal law. Each state has flexibility in deciding what constitutes the "retirement system" for referendum purposes, but there are limitations on the ability to subdivide a retirement system that covers the positions of employees of a single political subdivision. For example, a state may not conduct one referendum for the elected officials of a political subdivision and a second referendum for all other employees of the political subdivision, all of whom are covered under a single retirement system.

A referendum for Social Security coverage is a matter of state law, but it still must meet certain federal minimum requirements. In order to extend coverage to a retirement system coverage group, the state's governor (or his or her designee) must certify that the following minimum requirements were met:

— The vote was held by secret written or electronic ballot. (Federal law does not prescribe the ballot format or the voting mechanics.)

— The opportunity to vote was given and limited to the eligible employees of the retirement system (as determined by the state).

— The employees were given at least 90 days' notice of the vote.

— The vote was supervised by the governor or his or her designee.

— A majority of the eligible employees of the retirement system (not simply a majority of those voting) voted for coverage.

To be eligible to vote in the referendum, an employee must (1) be a member of the retirement system at the time the referendum is held and (2) be employed in a position under the retirement system both at the time the notice of the referendum is given and at the time the referendum is held. Employees are not eligible to vote if they are already covered by the state's Section 218 Agreement, are members of the retirement system but are not public employees, or are hired after the 90-day notice of the referendum is given and before the date the referendum is held.

If a referendum results in favor of coverage, the modification to the state's Section 218 Agreement to extend coverage must be executed within two years of the date of the referendum (and its effective date may be retroactive to avoid a gap in coverage). If the referendum is unfavorable to coverage, a new referendum with respect to the same retirement system cannot be held for at least one year from the date of the unfavorable referendum.[6]

2. Divided vote referendum process

[6] *See generally*, Social Security Administration Program Operations Manual System ("POMS") SL 30001.321; POMS SL 30001.322; POMS SL 30001.323.

A divided vote referendum process operates to extend Social Security coverage to all members of a retirement system who vote "yes" in the referendum and all new members of the retirement system going forward. Only individual members who vote "no" in the referendum are exempt from Social Security and only while they remain members. This means that if a member who voted "no" leaves the retirement system and later returns as a "new member," Social Security coverage is required.

> **Example 2**: A referendum was held among all the eligible members of MERS, a statewide system covering all municipal employees. A was an employee of City X and voted against coverage. After coverage was extended to the retirement system coverage group, A terminated his employment with City X and entered private employment. A withdrew his contributions from the retirement system. Two years later he is reemployed by City X. The State holds that he is a new member of MERS. A is a new member for purposes of coverage and is covered compulsorily.[7]

Individuals who vote "no" in a divided vote referendum may request a refund of the employee's share of Social Security contributions that were made on their compensation, if any, during the period open to correction (three years, three months, and 15 days after the end of the calendar year in which the wages were paid).

As noted above, a referendum for Social Security coverage is a matter of state law, but it still must meet certain federal minimum requirements. In order to extend coverage to a retirement system, the state's governor (or his or her designee) must certify that each of the minimum requirements discussed above with respect to the majority vote referendum process were met, with the exception that the ballots must identify the voting member (and not be a secret ballot) because a member's coverage will be based on his or her personal vote.

Following the vote, the retirement system must be divided into two parts, one composed of the members who voted for coverage and the other composed of the remaining members who did not elect coverage. Members who did not cast a vote are included in the group of members who did not elect coverage. The modification to extend coverage to the retirement system coverage group that voted in favor of coverage must be executed within two years of the referendum. The one-year time limitation for holding a new referendum after an unfavorable one also applies.[8]

II. SOCIAL SECURITY REPLACEMENT PLAN REQUIREMENTS

As explained above, Social Security coverage is mandatory for public employees who are not members of a "Social Security Replacement Plan" and who are not otherwise covered by Social Security under a Section 218 Agreement. A Social Security Replacement Plan is a pension plan maintained by a public employer that meets the requirements of Internal Revenue Code ("Code") Section 3121(b)(7)(F). These requirements, discussed below, generally mean that a Social Security Replacement Plan must provide a benefit that is at least as favorable to the employee as

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[7] POMS 30001.334.F.
[8] *See generally*, POMS SL 30001.331.

that employee would receive under Social Security. For this reason, a Social Security Replacement Plan is permitted as an alternative to mandatory Social Security coverage for public employees.

No approval of Social Security Replacement Plan status is required.

No approval is required by the Internal Revenue Service ("IRS") to certify that a plan meets the minimum requirements of a Social Security Replacement Plan. However, in situations where it is not clear that the rules are met, an employer may wish to obtain a private letter ruling from the IRS that the plan is in fact a Social Security Replacement Plan. If an employer's plan does not qualify as a Social Security Replacement Plan, the employer may be liable for payment of Social Security taxes for all open tax years affected, plus interest and penalties.

A. General Requirements of a Social Security Replacement Plan

A Social Security Replacement Plan is defined in the regulations under Code Section 3121 as having two main requirements: (1) the system must provide retirement-type benefits; and (2) the system must provide a minimum level of benefits with respect to an employee.

1. Retirement-type benefits

A Social Security Replacement Plan "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."[9] This definition excludes retiree health and other welfare benefits, but is otherwise notably broad in including most plans that are designed to provide a deferred benefit at the time of retirement. The regulations specifically state that the legal form of the plan is generally not relevant and may include a plan described in Code Section 401(a), an annuity plan or contract under Code Section 403, or a plan described in Code Section 457(b) or Code Section 457(f).[10] A Social Security Replacement Plan may be either a defined benefit plan or a defined contribution plan.

2. Minimum level of benefits

The definition provided above is limited with respect to an employee by Treasury Regulation Section 31.3121(b)(7)-2(e)(2), which requires that a Social Security Replacement Plan provide "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 plan meets this minimum level of benefits is determined on an individual-by-individual basis. Therefore, a public retirement system may qualify as a Social Security Replacement Plan for one participant and not qualify as a Social Security Replacement Plan for other participants.

Social Security Replacement Plan status is determined on an individual basis.

[9] Treas. Reg. § 31.3121(b)(7)-2(e)(1).
[10] *Id.*

Waiting periods, minimum age or service requirements, rules that restrict accruals to participants who are employed on the last day of the plan year, and other provisions that may vary by participant can impact the status of whether a retirement system serves as a Social Security Replacement Plan with respect to individual members. Except with respect to part-time, seasonal, and temporary employees, vesting provisions generally do not impact this analysis. These conditions should be avoided to the extent an employer wants all employees to be excluded from Social Security coverage.

B. Defined Benefit Social Security Replacement Plans

With respect to defined benefit plans that are intended to serve as a Social Security Replacement Plan, the regulations state:

> 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.[11]

Given the onerous burden of determining whether a retirement plan provides a minimum level of benefits to each individual employee, the regulations further provide that the IRS may, through guidance of general applicability, designate additional testing methods to satisfy this minimum level of benefits requirement on a group basis as opposed to an individual employee basis.[12]

1. Safe harbor rules under Revenue Procedure 91-40

Revenue Procedure 91-40, 1991-2 C.B. 694, sets forth defined benefit retirement system safe harbor formulas that a state or local governmental entity may use to satisfy the minimum level of benefits requirement for a Social Security Replacement Plan. If benefits for all participants in a retirement system are calculated under a safe harbor formula, the system is deemed to meet this requirement with respect to all participants, and, therefore, the participants of that retirement system will be exempt from mandatory Social Security coverage.

The safe harbor rules for a defined benefit plan provide minimum standards. A Social Security Replacement Plan may provide greater benefits. The basic parameters of the safe harbors prescribed under Revenue Procedure 91-40 are as follows:

— **Benefit multiplier:** A single life annuity payment must equal at least 1.5% of an employee's compensation during the employee's final or highest average

[11] Treas. Reg. § 31.3121(b)(7)-2(e)(2)(ii).
[12] Treas. Reg. § 31.3121(b)(7)-2(e)(2)(vi).

compensation period multiplied by each year of creditable service. The benefit multiplier must be greater than 1.5% in circumstances indicated below.

— **Average period of compensation:** The average period of compensation must generally be based on an employee's compensation over one of the following periods:

- the last 36 (or fewer) months of service;
- the 36 (or fewer) consecutive or nonconsecutive months of service that provide the highest average; or
- the high consecutive or nonconsecutive or the final 3 (or fewer) calendar or plan years of service.

If a plan uses an average period of compensation that exceeds 36 months, the benefit multiplier used to calculate a single life annuity payment must be greater than 1.5% according to the following schedule:

- 37-48 months: 1.55%
- 49-60 months: 1.60%
- 61-120 months: 1.75%
- Over 120 months: 2.00%

— **Retirement age:** The safe harbor formula contemplates a benefit payable no later than age 65. If a plan has a normal retirement age that exceeds age 65, it must consider the benefit payable at age 65 (with applicable reductions made for early retirement) when testing the plan's formula under the safe harbor rules.

— **Creditable service:** Creditable service must include all years worked with a permissible maximum of 30 years. If a plan limits creditable service to fewer than 30 years, the benefit multiplier used to calculate a single life annuity payment must be increased by a ratio of 30 to the plan's lower limit.

— **Compensation:** Compensation must generally be no less inclusive than the definition of the employee's base pay as designated by the employer or the retirement system, provided the designation is reasonable under all the facts and circumstances. Amounts above the Social Security taxable wage base may be disregarded.[13] In 2025, the Social Security taxable wage base is $176,100. However, if the plan's definition of compensation is less inclusive than otherwise required by the safe harbor rules, *e.g.*, if compensation under the plan is limited below the Social Security taxable wage base, then the benefit multiplier used to calculate a single life annuity must be increased by a ratio of aggregate compensation under the safe harbor rules to aggregate compensation under the plan's lower limit. This compensation ratio must be determined separately for each

[13] Treas. Reg. § 31.3121(b)(7)-2(e)(2)(iii)(B).

employer that participates in the plan and, therefore, may produce different results for different participating employers under a statewide retirement system.

Legislative proposals to reduce benefit levels for Social Security Replacement Plans must be carefully monitored.

State legislatures often look to pension reform to address budgetary concerns. However, when a legislative bill proposes to reduce benefit levels for a Social Security Replacement Plan, all changes should be carefully reviewed by legal counsel to determine if the changes may result in the plan losing its status as a Social Security Replacement Plan. If unchecked, legislative changes intended to reduce spending inadvertently could increase spending by triggering application of Social Security taxes on the wages of state and local employees. The increase in FICA taxes paid by the employer and employee (12.4%, split evenly) could be far greater than the reduction to pension contributions.

2. Alternatives to the safe harbor formula

If a defined benefit retirement system's benefit formula does not meet the safe harbor requirements described above, even after making adjustments to the benefit formula's multiplier, the retirement system may still meet the minimum benefit requirement of a Social Security Replacement Plan under one of the following alternative methods:

— **Safe harbor equivalent:** The retirement system must be able to demonstrate that an employee's accrued benefit is at least as great as the accrued benefit that the employee would have had if his or her benefit had been calculated under the safe harbor formula. In making this calculation, the retirement system must follow the rules above regarding the safe harbor factors. For example, a plan that provides only for single sum distributions may still meet the safe harbor requirements under this alternative with respect to an employee if it provides a single sum with respect to such employee that is the actuarial equivalent (using reasonable actuarial assumptions) of a single life annuity that meets the safe harbor formula.[14]

— **Social Security equivalent:** The retirement system must be able to demonstrate that an employee's accrued benefit is at least as great as the employee's Social Security benefit would have been had the employee been covered by Social Security. This method requires an individual benefit comparison.[15]

Under either of these approaches, an actuary would be needed to provide the analysis to determine if the IRS requirements have been met.

3. Potential use of defined contribution plan requirements

In Private Letter Ruling (PLR) 9746005, the IRS ruled on whether a defined benefit plan could meet the minimum requirements of a Social Security Replacement Plan by satisfying the

[14] Rev. Proc. 91-40, § 4.01.
[15] Treas. Reg. § 31.3121(b)(7)-2(e)(2)(ii).

rules applicable to defined contribution plans, rather than the rules applicable to defined benefit plans under the regulations and Revenue Procedure 91-40. The plan in that case was a defined benefit cash balance plan that required a minimum 4% employee contribution and 4% employer contribution. The nominal account balances of the employees were credited with a minimum interest rate that was determined annually, but in no event would be less than the average interest rate on 30 year Treasury obligations for the 12 months preceding the plan year.

In its ruling, the IRS discussed the meaning of a "defined contribution plan" for purposes of Treasury Regulation Section 31.3121(b)(7)-2 and concluded that it was not limited by the definition of a defined contribution plan found in Code Section 414(i). Accordingly, the IRS concluded that the defined benefit retirement plan described in the ruling would meet the minimum requirements of a Social Security Replacement Plan, provided the rules related to defined contribution plans were satisfied. Those rules are discussed in Part II.C.

Of course, the PLR does not constitute binding guidance and applies only with respect to the employer to which the ruling was issued. Notwithstanding, it provides public employers with insight as to how the IRS may view a cash balance or hybrid defined benefit plan design that satisfies the Social Security Replacement Plan rules applicable to defined contribution plans.

No clear guidance for cash balance and hybrid defined benefit plans.

It has been over 30 years since the IRS issued its safe harbor guidance for defined benefit Social Security Replacement Plans under Revenue Procedure 91-40. Unfortunately, the guidance does not address the ways in which defined benefit plan models have evolved, specifically, with the prevalence of cash balance and hybrid defined benefit plans. While the above-cited private letter ruling is helpful, an employer may not rely upon the PLR in the event the IRS challenges the employer's exclusion of wages from Social Security taxes. Until further guidance is issued, employers should continue to evaluate non-traditional defined benefit designs under the framework of Revenue Procedure 91-40, using actuarial determinations, to ensure that their plan designs are Social Security Replacement Plans.

C. Defined Contribution Social Security Replacement Plans

A defined contribution plan is a Social Security Replacement Plan with respect to an employee on a given day:

> if, on that day, he or she has satisfied all conditions (other than vesting) for receiving an allocation to his or her account (exclusive of earnings) that meets the minimum retirement benefit requirement of [a Social Security Replacement Plan] with respect to compensation during any period ending on that day and beginning on or after the beginning of the plan year of the retirement system. This is the case regardless of whether the allocations were made or accrued before the effective date of [this section].[16]

[16] Treas. Reg. § 31.3121(b)(7)-2(d)(1).

The minimum retirement benefit requirements for defined contribution plans are as follows:

1. Minimum contribution requirement

Allocations to the employee's account (not including earnings) for a period must be at least 7.5% of the employee's compensation for service during the period. The 7.5% allocation may be comprised of all employee money, all employer money, or a combination of employee and employer money.[17] A defined contribution plan that does not provide a 7.5% benefit with respect to all eligible employees will not be a Social Security Replacement Plan.

2. Definition of compensation

The definition of "compensation" under the plan must generally be no less inclusive than the definition of the employee's base pay as designated by the employer or the retirement system, provided such designation is reasonable under all the facts and circumstances. A defined contribution plan will not fail to be a Social Security Replacement Plan because its definition of compensation excludes for all purposes any one or more of the following: overtime pay, bonuses, or single-sum amounts received on account of death or separation from service under a bona fide vacation, compensatory time or sick pay plan, or under severance pay plans. In addition, amounts above the Social Security taxable wage base may be disregarded.[18] In 2025, the Social Security taxable wage base is $176,100.

3. Reasonable Interest Rate Requirement

The plan must either: (i) credit the employee's account with earnings at a rate that is reasonable under all the facts and circumstances; or (ii) hold employees' accounts in a separate trust that is subject to general fiduciary standards and credit such accounts with actual earnings on the trust fund. Whether the interest rate under (i) is reasonable is determined after reducing the rate to adjust for the payment of any administrative expenses.[19]

D. Special Rules for Part-Time, Seasonal, and Temporary Employees

In addition to the general rules outlined above, the regulations include special rules for part-time, seasonal, and temporary employees which afford this group of employees with additional protections in order for their wages to be excluded from Social Security coverage.[20] For purposes of the special rules, these terms are defined as follows:

— A **part-time employee** is any employee who normally works 20 hours or less per week. A teacher employed by a post-secondary educational institution is not considered a part-time employee if he or she normally has classroom hours equal to at least one-half of the number of classroom hours designated by the educational

[17] Treas. Reg. § 31.3121(b)(7)-2(e)(2)(iii)(A).
[18] Treas. Reg. § 31.3121(b)(7)-2(e)(2)(iii)(B).
[19] Treas. Reg. § 31.3121(b)(7)-2(e)(2)(iii)(C).
[20] Treas. Reg. § 31.3121(b)(7)-2(d)(2).

institution as constituting full-time employment, provided that the designation is reasonable under the circumstances.

— A **seasonal employee** is any employee who normally works on a full-time basis less than five months in a year.

— A **temporary employee** is any employee performing services under a contractual arrangement with the employer of two years or less duration. Possible contract extensions may be considered in determining the duration of a contractual arrangement, but only if, under the facts and circumstances, there is a significant likelihood that the employee's contract will be extended.

For purposes of these rules, elected officials are not considered part-time, temporary, or seasonal employees.[21]

A plan is not a Social Security Replacement Plan for these individuals unless they, at all times, have a nonforfeitable benefit which satisfies the minimum requirements of a Social Security replacement plan (the "fully vested rule"). The fully vested rule generally requires that the benefit relied upon to meet the Social Security Replacement Plan rules must be 100% vested as of any given day. The fully vested rule will be deemed to be met if an employee is unconditionally entitled to a single-sum distribution on account of death or separation from service of an amount that is at least equal to 7.5% of compensation, adjusted for interest at a rate meeting the requirements applicable to defined contribution Social Security Replacement Plans. The regulations provide the following example to illustrate this rule:

> *Example*. An employee is required to contribute 7.5 percent of his or her compensation to a State's defined benefit plan each year. The contribution is "picked up" by the employer in accordance with section 414(h). Under the plan, these amounts plus interest accrued since the date each amount was contributed are refundable to the employee in all cases upon the employee's death or separation from service with the employer. If the interest rate meets the requirements of paragraph (e)(2)(iii)(C) of this section, then the employee's benefits under the plan are considered nonforfeitable and thus meet the requirement of paragraph (d)(2)(i) of this section. Of course, the benefit under the plan must still meet the minimum retirement benefit requirement for defined benefit plans of paragraph (e)(2)(ii) of this section.[22]

Vesting provisions applicable to part-time members should be carefully reviewed.

Generally, the fully vested rule can be satisfied in a defined benefit plan that provides a refund of member dues for non-vested members, but only to the extent member dues equal or exceed 7.5% of compensation. Likewise, the fully vested rule can be satisfied in a defined contribution plan if contributions of at least 7.5% of compensation are not subject to vesting. Employers that

[21] Treas. Reg. § 31.3121(b)(7)-2(d)(2)(iii).
[22] Treas. Reg. § 31.3121(b)(7)-2(d)(2)(i), (ii).

do not wish to satisfy these rules with respect to all employees should adopt separate plans (or coverage tiers) only for part-time, seasonal, and temporary employees.

III. <u>ELIMINATION OF SOCIAL SECURITY WEP AND GPO REDUCTIONS</u>

For Social Security benefits payable prior to January 1, 2024, there were two provisions that had long operated to potentially limit an individual's Social Security benefit if they had spent a portion of their career in a position not covered by Social Security: the Windfall Elimination Provision ("WEP") and the Government Offset Provision ("GPO").

— The WEP was a reduction to a worker's *<u>own</u>* Social Security benefit because of a pension earned by the worker in non-covered employment. The Social Security benefit formula replaces a higher percentage of income for lower wage workers by weighting income replacement higher at lower income tiers. The WEP operated to reduce the amount of income that was replaced under the first (lowest) tier of the Social Security benefit formula based on the view that not making an adjustment in this situation would produce a windfall to the worker by replacing a greater percentage of income than was intended.

— The GPO was a reduction to a worker's *<u>spouse or survivor</u>* Social Security benefit because of a pension earned by the worker in non-covered employment. The GPO operated similarly to Social Security's dual-entitlement rule, which reduces the potential spouse or survivor benefit of a worker by the worker's own retirement benefit (based on the worker's own earnings record). The dual-entitlement rule results in offsetting the spouse/survivor benefit so that it is only paid if – and to the extent it exceeds – the worker's own retirement benefit. The GPO was intended to achieve similar results as the dual-entitlement rule with respect to workers who earn a pension from a government job that is not covered by Social Security by reducing a worker's Social Security spouse or survivor benefit by two-thirds (2/3) of the amount of the government pension earned by the worker in non-covered employment.

On January 5, 2025, the Social Security Fairness Act ("Act") was enacted, repealing both the WEP and the GPO, effective for monthly benefits payable after December 2023. The Act directs the Commissioner of Social Security to adjust the benefits payable to impacted beneficiaries to the extent necessary. While the repeal of the WEP and GPO has no direct impact on retirement plan administration, it may affect member communications around the interaction between Social Security benefits and earning a pension in non-covered employment.

Importantly, the Act did not repeal the requirement that State and local governments provide an explanatory statement to employees hired January 1, 2005 or later in jobs not covered by Social Security. However, to reflect the repeal of the WEP and GPO, Social Security has updated Form SSA-1945, *Statement Concerning Your Employment in a Job Not Covered by Social Security*, to more generally explain to an employee that non-covered earnings will not be used to determine eligibility or to calculate the amount of potential future benefits (eliminating the discussion regarding WEP and GPO). Thus, the requirement for employers to obtain signed copies of Form SSA-1945 from employees not in a Social Security covered position, and to return signed copies to the public retirement system, continues to apply.[23]

CONCLUSION

The application of Social Security taxes to state and local governments and their employees is dependent on multiple factors. Public employers that cover their employees under Social Security should understand how that coverage applies. If Social Security applies under a Section 218 Agreement, the employer cannot terminate the coverage, nor can it increase retirement benefits in order to "replace" the coverage. On the other hand, if Social Security applies on a mandatory basis, an increase in benefits to the level of a Social Security Replacement Plan will cause the Social Security coverage to end. Public employers that do not cover their employees under Social Security must likewise understand that the basis of that exclusion relies on the employer maintaining a minimum level of retirement benefits. Any change or reduction to retirement benefits should be closely reviewed to avoid unintended results. While these rules can be challenging to navigate, public employers and retirement systems that are able to apply the appropriate coverage status (and tax treatment) to employees at the outset have an easier time than if the errors are later identified by the IRS or Social Security Administration.

[23] *See* Instructions for Form SSA-1945 (updated March 2025).

APPENDIX A

I. TIMELINE OF RELEVANT DATES

1937

— Social Security taxes are first collected
— All state and local government employees are excluded

1951

— States may voluntarily elect Social Security coverage for public employees not covered by a public retirement system
— Coverage is provided through a Section 218 Agreement entered into between the state and the Social Security Administration
— All 50 states have a Section 218 Agreement

1955

— States are permitted to extend Social Security coverage to public employees who are covered by a public retirement system
— Referendum process is required to allow employees to vote for coverage

1983

— Social Security coverage secured through a Section 218 Agreement (including by modification thereto) cannot be terminated unless the governmental entity is legally dissolved

1991

— Social Security coverage becomes mandatory for all public employees who are not either:
- already covered by Social Security through a Section 218 Agreement or
- covered by a public retirement system that provides a minimum benefit to qualify as a replacement to Social Security coverage (a Social Security Replacement Plan)

II. GOVERNMENT RESOURCES

— Treasury Regulation 31.3121(b)(7)-2

— Revenue Procedure 91-40

— IRS Publication 963: Federal-State Reference Guide

— Social Security Administration guidance under POMS
https://secure.ssa.gov/apps10/poms.nsf/partlist!OpenView

