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**Social Security Integration and Permitted Disparity**

***Why is my pension check smaller than I expected?***

1. Both the employee’s retirement plan through the employer and the employee’s share of social security are designed to replace that employee’s pre retirement income.
2. The Employer can integrate a certain percentage of the employee’s anticipated social security benefit, “permitted disparity”, with the employee’s pension plan.

***What is Social Security Integration?***

1. Integration of the employee’s retirement plan with the anticipated Social Security benefits that that employee is going to receive allows employers to partially offset the contributions made by the employer.
   1. Excess plan: they are the most common form of integration today. Excess formulas can be used in traditional defined benefit plans or in defined contribution plans.
      1. The dollar level that divides the higher and lower rates can be social security covered compensation:
         1. the average of the social security taxable wage bases in effect for each of the previous 35 years or
         2. the social security taxable wage base,
         3. or an arbitrary dollar amount.
      2. The difference between benefits or contributions above and below this integration level is strictly limited by law = “permitted disparity”
      3. Changes to the taxable wage base will affect excess plans, which typically rely on either covered compensation or the taxable wage base as their integration point. Increases in the taxable wage base will reduce the number of employee’s receiving benefits above the integration level.
2. Under the current law, private sector employers may take the availability of the social security benefits into account in their benefit plan formulas. The employer can only integrate up to a certain level or a “permitted disparity.” The rationale for integration, or, more correctly, “permitted disparity”, rests on the employer payment of ½ of the social security payroll tax and on the fact the Social Security benefits are weighted to lower wage levels.
3. The percentage of earnings that is replaced by Social security falls as income rises, dropping from 90% for workers with the lowest earnings to approximately 25% for those with earnings that are always at the maximum table amount ($87,900 for 2004).
4. Without integration, some low-wage workers who had long service with an employer could receive combined Social Security and pension benefits that would come close to or exceed their earnings before retirement. That situation could discourage someone from continuing to work. With integration, however, more of the benefits of the employment-based plans go to higher wage workers. In fact, because integration could effectively negate the nondiscrimination and top-heavy rules, plans are limited in the extent to which they can integrate and the methods they can use.
5. Because Social Security benefits are based on the employee’s compensation and only cover up to the employee’s wage base, a permitted disparity allows the employer to provide higher (disparate) benefits with respect to the portion of an employee’s compensation that is not take into account under the social security system
6. With integration, pension benefits are lowered for lower income pensioners because and total retirement benefits (pension + social security) replace a percentage of the final pay.

***What is the difference between permitted disparity and integration?***

1. Integration: Under old law, an employer could fully integrate the pension plan with the Social Security benefits that Social security integration meant that the employer could fully integrate its retirement plan with social security system. In certain plan designs that meant the employer provided no benefits to persons at lower income levels.
2. Permitted disparity: Under current law, it is permitted for the employer to have a limited gap in coverage that is related to social security benefits, but the employer cannot rely solely on social security at any wage level.
   1. NOTE: a plan that has no Highly Compensated Employees[[1]](#footnote-1), does not have to meet the permitted disparity requirements.
   2. If there are Highly Compensated Employees in the plan, then the ER can choose to elect the “permitted disparity” requirements for the safe harbor, i.e. no more than 50% of the participant’s benefit can be integrated with Social Security.
   3. If the plan does not want to follow the safe harbor, no more than 50%, then it must meet the general test requirements.

***Do the Permitted Disparity Rules Apply to both Defined Contribution and Defined Benefit Plans?***

1. This integration or permitted disparity is prevalent in both defined contribution and defined benefit plans.
2. **Defined Contribution Plans[[2]](#footnote-2)**:
   1. The plan must be a defined contribution excess plan.
   2. The maximum disparity cannot exceed the base contribution percentage (i.e., 1% of pay) or the varying rates
      1. Varying rates permitted based on integration levels[[3]](#footnote-3)
         1. 100% of wage base – 5.7%[[4]](#footnote-4)
         2. More than 80% but less than 100% of wage base – 5.4%
         3. More than the greater of 20% of the targeted wage base or $10,000 but no more than 80% of targeted wage base = 4.3%
3. **Defined Benefit Plans**: The amount of disparity that is permitted under a defined benefit plan is approximated on the rate at which the social security benefits will replace that employee’s earnings.
   1. The integration level under a defined benefit excess plan or the offset level must:
      1. The integration or offset level under the plan for each employee is a uniform percentage of each employee’s covered compensation,
      2. In the case of a defined benefit excess plan, the integration level cannot not exceed the taxable wage base in effect for the plan year and, in the case of an offset plan, the offset level does not exceed the employee’s final average compensation
      3. The plan adjusts the 0.75% factor in the maximum excess or offset allowance if the integration or offset level exceeds covered compensation.

***My Employer sponsors a Defined Benefit Plan; how is my benefit calculated?***

* 1. Your defined benefit plan may used one of the following **formulas to compute your pension benefit**
     1. **Flat benefit** – e.g. $300 per month
        1. This benefit will provide you with a certain amount per month that will not fluctuate.
        2. You will have to meet the vesting requirements in the plan.
     2. **Fixed benefit** – e.g. 40% of pay (See table below)
        1. you will receive 40% of your salary as an annual benefit
        2. You have a salary of $85,000, then the employer will pay you $34,000 provided you meet all the vesting requirements of the plan.
     3. **Unit credit** – 1% of pay on base pay:
        1. If your salary was $65,000 and you are participating in the plan, the employer will credit your account with $650 per year of participation in the plan. You must meet the vesting requirements under the plan.
     4. **Cash balance** –defined contribution plan that looks like a defined contribution plan, i.e. individual account balances for the participants.
        1. The employer will provide a hypothetical account for the participant and it will provide a unit credit for the years of participation in the account.
  2. **Pay**: this will be the pay that the Employer will use in the benefit formula above.
     1. **Career average (see table below)**
        1. This will be the average salary that you earned with the particular employer.
        2. Take your total pay and divide that by the number of years of service: this will give you your average pay.
     2. **Final average: (See table below)**
        1. the compensation paid to a participant by the employer for any year:
           1. which ends during the certain year period ending with the year in which the participant separated from service for the employer; and
           2. For which the participant’s total compensation from the employer was the highest.
     3. **High X year average. (See table below)**
        1. The employer will choose a certain 3 or 5 year period that it will use to compute the benefit formula.

***What authority do employers have to integrate?***

* 1. Employers say that they are contributing both to social security and the pension plans: they are contributing to two forms of retirement for their workers.
  2. Since their contributions to social security are comparatively larger for lower-wage workers – in percentage if not amounts—they believe that they ought to get credit for these amounts and subtract them from pensions.
  3. The purpose for integration is to keep employers’ costs down and to allow them to offer a larger pension share to favored management-level employees.

***Does my plan have Social Security Integration?***

1. 401(k), Simplified Employee Pension (SEP) and Employee Stock Ownership Plans (ESOPs) may not be integrated.
2. Step rate is the only permitted way an employer can integrate a Defined Contribution plan.
3. AN employer’s Defined Benefit plan can be integrated either by the offset approach or the step rate approach.
   1. Employee needs to determine whether the plan is taking more than permitted under 1.401(l) et seq. are allowed to under the integration regulations. Some Employer’s might use the incorrect figure. (See DC and DB description above)
   2. Plans typically use estimates of employee’s social security benefits based on the assumption that they have worked continuously.
   3. For people who drop out of the workforce, these estimates will be higher than their benefits.
   4. PA is required to notify people when they retire of their right to have their pensions recalculated based on their actual social security payments.
   5. The MAXIMUM OFFSET allowances cannot exceed 50% of the benefit that would have accrued without the offset reduction.

***Is my plan integrated if I work for the Federal Government or State Government?***

Prior to 1984, under the Civil Service Retirement System (CSRS), the federal government and many states and localities chose not to participate in Social Security so there was no need to integrate their pension plans with it. Participation in Social Security at the state and local level is now common. Employees hired later, under the Federal Employee Retirement System (FERS) (and some hire earlier who voluntarily switched) are covered by social security and a different pension system, but system is not explicitly integrated.

***What are the different ways an employer can integrate a plan?***

1. there are three approved methods for integration for a defined benefit plan: step rate plans and offset plans
   1. **Step Rate:** an integrated pension typically will offer greater benefits to participants whose earnings are higher than a prescribed wage level – integration level.
      1. The integration level is set by law and has a maximum amount is $87,900 for 2004.
      2. Retirement plans integrate through a “step-rate” method – by reducing the plan’s replacement rate for earnings that are subject to Social Security taxes relative to the rate for earnings above the Social Security maximum wage base.
      3. Example: plans might replace terminal wages of up to $87,900 at the rate of 1.48 percent per year of service but then replace wages in excess of $87,000 at a rate of 1.98 %. For an employee w/ 30 years of service, that method of integration would effectively extend Social Security’s replacement rate bracket of 15% to earnings above the maximum taxable wage base= for which the statutory replacement rate is zero.
      4. **Step rate** **requirements**: 1% of pay on base pay, plus 1.5% of pay in excess:
         1. Limits:
         2. The difference between the rates cannot exceed the lesser of the base rate or .75%
         3. The number of years includible in the integration formula limited to 35
         4. Only years with sponsor can be counted.
   2. **Offset Plan**: Offset directly takes Social Security benefits into account by reducing pension benefits for each dollar in Social Security benefits received.
      1. The maximum permitted pension reduction is ½ of the annual Social Security benefit.
      2. Example: If an employee with 30 years of service and $40k of wages was covered under a typical defined benefit plan and had a primary Social Security benefit of $10,000, the pension in the integrated plan would fall from $17,760 to $12, 760. $10,000 x 50% = $5,000. Then subtract this from the pension of $17,760 = $12, 760.

***How do I calculate my benefit?***

1. A plan that is using integration is allowed to offset a certain portion of the participant’s retirement benefit which is called a permitted disparity.
2. The employer is limited in the percentage reduction in Social Security benefits that can be applied and the percent of benefits permitted above the integration level when using the step-rate approach.

**EXAMPLES OF PERMITTED INTEGRATION FOR PENSION PLANS**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Calculation | Offset | Step-rate |
| Final Earnings | Final 3 year average | $65,000 | $65,000 |
| Annual Social Security Benefit | Primary insurance amount x12 | $12,000 | $12,000 |
| Annual Pension Benefit Before Integration | 30 years x $65,000 x 1.5% (the percentage that the plan promises) | $29,250 | $29,250 |
| Integration Adjustment:  Offset (1/2 of annual Social Security benefit)  Step-Rate Approach: integration level of $40,000 – maximum integration level is $87,900  1% of earnings up to $40,000  1.5% of earnings of $40,000 and over | ½ of $12,000 (line 2)  30 years x $40,000 x 1%  30 years x $25,000 x 1.5% | $6,000 | $16,500  $12,000  $4,500 |
| Annual Pension After Integration | Offset: $29,250 (line 3) minus $6,000 (line 4) | $23,250 | $16,500 |
| Total Annual Benefits After Integration | Offset: $12,000 (line 2) plus $23,250 (line 5)  Step rate: $16,500 (line 5) plus $12,000 (line 2) | $35,250 | $28, 500 |

\* This table is adopted from examples provided by 401(l) regulations.

1. Benefits for Workers with integrate Defined Benefit Plans under the Offset approach:
   1. A worker has a pension plan that specifies benefits equal to 1.5% of average earnings in the five years prior to retirement, multiplied by years of service, reduced by 50% of the worker’s social security benefit. Under this plan, a worker with final five-year average earnings of $65,000 and expected Social Security benefits of $12,000 would receive an annual pension of $23,250. The integrated pension would be calculated as follows for a 30-year employee:
      1. The worker’s annual pension benefit prior to integration with Social Security is $29,250 (computed by multiplying $65,000 by 30 years and taking that sum and multiplying it by 1.5%)
      2. The worker’s pension benefit after integration with social security is $23,250 (different between the prior pension amount (29,250)
      3. The total annual benefits (pension and Social Security) is $35,250. This is $6,000 less than the total benefit would have been if the pension plan had not been integrated and the two benefits had simply been added together.
2. Benefits for Workers with Integrated Defined Benefit Plans Under the Step-Rate Approach
   1. A step-rate approach involves two benefit percentages: the first, or “base” rate, is a percentage that applies to earnings up to the integration level; the second, or “excess” rate, is the percentage applied to earnings at and above the integration level. A pension plan may set the integration level at a value at or below the MTEB.
   2. The plan may use a base rate of 1% up to an integration level of $40,000 and an excess rate of 1.5% above the $40,000. In this case, the worker with the final average annual earnings of $65,000 and expected annual Social Security benefits of $12,000 would receive an annual pension benefit of $16,500. The annual pension benefit before integration is $29,250.
   3. the pension benefit is the sum of the two benefit percentage calculations. The first is the $40,000 multiplied by 30 years, which is then multiplied by 1%, which is $12,000. The second -- $10,000 multiplied by 30 years, which is then multiplied by 1.5% -- is $4,500. The sum -- $16,500, is the annual pension.
   4. The total annual benefit after integration is $28,500 -- $12,750 less than the total benefit of $41,250 if the plan had not been integrated.

**Where does the Employer get the authority to integrate Social Security with my benefits?**

1. The rationale this rests on the employer payment of one-half of the social security payroll tax and on the fact that social security benefits are weighted toward lower wage levels.
2. Internal Revenue Code Section 401(l) lists the requirements for permitted disparity.

***Is there anything that I need to be concerned with if my benefit is integrated?***

Look at your plan and determine how your benefit is being calculated with your social security offset. :

1. The integration level has to be uniform dollar amount for all participants that is not in excess of the taxable wage base for 2005.
   1. The integration level is the amount of compensation specified in the plan at or below which the rate of contributions is less than the rate for compensation above this amount.
   2. If the integration level under the plan is less than the TWB, the maximum permitted disparity may be less than the disparity permitted if the integration level were the TWB.
   3. The base contribution percentage is the rate at which contributions and forfeitures are allocated on compensation oat or below the integration level. The excess contribution % is the rate at which contributions and forfeitures are allocated on compensation above the integration level.
   4. The excess contribution % may not exceed the base contribution by more than the maximum excess allowance. The maximum excess allowance is the lesser of the base contribution percentage or the percentage described in line f.

***Who do I contact with more questions about Social Security Integration?***

1. Social Security Administration
2. Department of Labor
3. Internal Revenue Service
4. Pension Rights Center

1. § 414(q) defines an Highly Compensated Employees as an employee who (**i**) was a “5% owner”; or (ii) for the preceding plan year had compensation from the employer in excess of $90,000. (In determining who is an HCE on the dollar prong, you can make a top group election, you can limit the top paid to the top 20%. This helps where you have a higher paid workforce.) For purposes of determining the number of employees in the top-paidgroup, the following employees are excluded: (i) new employees with less than 6 months ofservice, (ii) part-time employees who normally work less than 17½ hours per week, (iii) seasonalemployees who normally work during not more than 6 months during any year, and(iv) employees who have not attained age 21.**LOOK BACK**: need to look back to the prior year for the dollar test [↑](#footnote-ref-1)
2. 1.401(l)-2 [↑](#footnote-ref-2)
3. 1.401(l)-2(d)(4)(ii). [↑](#footnote-ref-3)
4. Targeted wage base is $87,900 for 2004. [↑](#footnote-ref-4)