Discretionary profit sharing contributions can come in many “flavors”. Some employers simply seek to give all eligible participants an equal share of the allocation, by utilizing a formula that provides a uniform percentage of compensation or uniform dollar amount. This is generally a simple contribution to calculate and administer.

On the opposite end of the spectrum, some employers use a new comparability allocation formula (sometimes referred to as “cross-testing”), whereby plan participants are divided into allocation groups, and the amount allocated to the participants in each group varies. This type of formula allows employers to give the maximum contribution to select individuals, usually owners or other key employees. However, it is subject to special rules and testing requirements that make the administration of the plan more costly.

But for employers seeking to provide an extra benefit to certain individuals without the additional administrative costs and testing requirements of cross-testing, a good alternative is to utilize a permitted disparity allocation formula, commonly referred to as “integration”, in that it is designed to integrate the payments that the employer makes to the Social Security system with the allocations made to the retirement plan.

When determining retirement benefits, Social Security effectively “discriminates” in favor of lower paid employees because it only considers compensation up to a certain level – known as the Social Security Taxable Wage Base (SSTWB). The SSTWB for 2017 is $127,200. Therefore, for 2017, the mandatory employer contribution to the Social Security system is only based on the first $127,200 of an employee’s pay. Individuals who earn more than the SSTWB therefore have a lower benefit-to-compensation ratio than individuals who earn less than the SSTWB.

Because of this discrimination, the Internal Revenue Code allows employers to allocate a higher rate of plan contributions on pay over the SSTWB, or some portion of the SSTWB, as defined in the plan document. The amount used as the cutoff level in determining the compensation on which the higher rate will apply is called the “integration level”. The integration level can never be greater than the SSTWB for the year, and is usually defined in relation to the SSTWB - for example, 100% of SSTWB; or 80% of SSTWB + $1; etc.

The analysis of permitted disparity involves a comparison of percentages, rather than dollar amounts, and there are restrictions on the contribution percentage allocated on pay exceeding the integration level. To understand the restrictions, one must first be familiar with the terminology used in the formula. The Excess Contribution Percentage (ECP) is the percentage of the
contribution that is allocated with respect to pay that exceeds the integration level. The **Base Contribution Percentage** (BCP) is the percentage of the contribution that is allocated with respect to pay that is less than the integration level. The rules, then, that apply to designing such a contribution formula are:

A. The ECP cannot be more than the lesser of: two times the BCP, or the BCP plus the disparity percentage.

B. The disparity percentage is a function of the integration level, as determined below:

<table>
<thead>
<tr>
<th>Integration level</th>
<th>Applicable disparity percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSTWB</td>
<td>5.7%</td>
</tr>
<tr>
<td>More than 80% but less than 100% of SSTWB</td>
<td>5.4%</td>
</tr>
<tr>
<td>More than 20% but less than 80% of SSTWB</td>
<td>4.3%</td>
</tr>
<tr>
<td>20% or less of SSTWB</td>
<td>5.7%</td>
</tr>
</tbody>
</table>

Assume these facts:

**ASSUMPTIONS**

Employee compensation = $270,000
SSTWB = $127,200
Integration level = 80% of SSTWB + $1 = $101,761
Base pay (pay up to integration level) = $101,761
Excess pay (pay over integration level) = $168,239 ($270,000 - $101,761)
Applicable disparity percentage from above chart = 5.4%

The allocation would be:

Step 1 allocation (BCP) = 3% of base pay (.03 * $101,761) = $3,052.83
Step 2 allocation (ECP) = 6% of excess pay (.06 * $168,239) = $10,094.34
Total allocation = $13,147.17

This formula is nondiscriminatory because the ECP is no more than 6% (the lesser of 3% plus 5.4% or two times 3%).

The important thing to note in the example above is the additional benefit received by the individual with total pay that is greater than the integration level. While an employee who earns up to $101,761 receives a 3% company contribution, an individual earning $270,000 actually receives a contribution equal to 4.87% of his total compensation.

Permitted disparity is a means by which an employer may choose to provide an extra benefit to plan participants whose compensation is above some defined level. There are many ways to design a permitted disparity formula, and it is helpful to run projections to determine which integration level, ECP and BCP will maximize the contribution allocation, while still staying within the employer’s budget.