

## • Government Plans May Cause Social Security Offset Trap for Unwary

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### What is a Social Security offset?

In the world of private-sector qualified plans, the concept that the existence of a qualified-pension or profit-sharing plan can cause a reduction in a participant's Social Security benefits is a completely foreign concept.

Nevertheless, if a qualified pension plan under Internal Revenue Code Section 401(a) is also a government plan, i.e., a plan adopted by a state or local government, or political subdivision, agency or instrumentality, the existence of a Social Security offset is a real possibility. The Social Security offset is of two varieties: the windfall elimination provision and the government-pension offset provision.

### Windfall Elimination Provision (WEP)

The WEP causes the reduction of the otherwise payable Social Security benefits if a government has elected to be excluded from Social Security coverage and if the government provides a pension that pays periodic payments to its retired employees. The law affects only individuals who are entitled to Social Security benefits based on employment with a prior employer such as a private-sector company that covers its employees under Social Security.

For example, if an agency, such as a water district, has opted out of Social Security and it adopts a defined-benefit pension plan, money-purchase pension plan or any other plan that provides a periodic payment, then any participant in such a plan who has worked for an entity that had Social Security coverage and earned a Social Security benefit will have his or her Social Security benefits reduced when retired. This can come as a surprise to the unsuspecting government employee who was counting on his or her Social Security benefit for retirement.

Individuals affected are those who worked for an entity covered by Social Security for 10 to 30 years. The extent of the reduction will depend on the amount of the pension and the amount of the Social Security benefits otherwise payable. The Social Security administration has published complex guidance as to how the calculation is computed. Moreover, they will advise the affected participant of the exact amount of the reduction.

The following example demonstrates how it works. Example: Retirement participant "A" had Social Security credited average-monthly earnings (hereinafter "earnings") of \$6,000. His Social Security benefits are calculated based on three-tiered calculation, which is adjusted for inflation.

- The first \$592 of earnings times 90 percent, \$523.80
- The next \$2,975 of earnings times 32 percent, \$952.00
- The remainder of \$2,435 times 15 percent, \$364.95

This would be a total monthly benefit of \$1,849.75

WEB reduces only the 90 percent factor in the first calculation above. The amount of the reduction is based on the number of years of substantial earnings in a job where A contributed to Social Security. If A had 21 years of substantial earnings, then the 90-percent factor is reduced more than if he had 29 years. The reduction would range from a low of \$29.60 a month to a high of \$266.40. If A had less than 20 years of substantial earnings, the 90-percent factor is reduced to 40 percent for a monthly reduction of \$296.00. *(Please note this is an example from 2002 and is intended to demonstrate the principle of how the reduction works.)*

### Government Pension Offset (GPO)

The Government Pension Offset reduces a person's Social Security benefits if those benefits are based on work of a spouse, rather than the work of the individual. These could be survivor benefits or benefits for a spouse with little or no Social Security benefits of his or her own. This offset occurs if the person otherwise entitled to Social Security as a spouse, also receives any retirement benefits from a government entity that has opted out of Social Security. The following example demonstrates how the GPO works.

Example: Mr. X, an employee of the ABC Water District, survives his wife, who was eligible for Social Security. Her

monthly Social Security benefit payment was \$800 a month. Without the GPO, Mr. X would be entitled to one-half of her \$800 pension for life or \$400 a month.

Mr. X had a monthly retirement from the Water District of \$1,000 per month. The GPO deduction of the otherwise payable Social Security payment of \$400 a month is reduced by two-thirds of Mr. X's monthly retirement from the Water District, or \$667. Accordingly, his Social Security entitlement of \$400 per month is reduced to zero.

Unlike the general rules governing private-sector plan, the term "pension plan" and the term "periodic payment" are not defined in any written guidance from the Social Security Administration. Moreover, the case law interpreting the statute fails to give any clear definition on what exactly constitutes a periodic payment from a pension plan of a government agency. We know from case law that CalPERS and other traditional pension plans, such as money-purchase thrift plan, are deemed to be pension plans. However, there is no discussion of how to define a pension plan. It is simply assumed that everyone knows.

There is no authority that mentions whether periodic payments from a 401(k) plan or a 457 plan are considered to be periodic payments from a pension plan. I have contacted the office of Social Security information number listed on the Social Security internet site and was told that the only way my client could get such an answer would be to contact the manager of the local office and ask for a written opinion.

To date I have been unable to locate any agency that has such a written opinion, therefore, the issue is presently unresolved.

### **Mandatory Notification by Governments with Pension Plans**

Legislation adopted in 2004 requires that each government agency that has opted out of Social Security must notify its affected employees of the potential reduction of Social Security benefits under WEP and GPO using Form SSA-1945 and the instructions.

Under the law, each affected employer must: give the statement to each employee prior to the start of employment; get the employee's signature on the form and; submit a copy of the signed form to the pension-paying agency. This was effective Jan. 1, 2005. The Social Security Administration may assess civil-monetary penalties for intentional failure to provide the statement.

Therefore, it is imperative that affected governments determine whether or not the WEB and/or the GPO provisions are applicable to employees who are part of a 401(k) plan and/or 457 plan. If the answer is affirmative, it is critical that the notice requirement be fulfilled.

### **What should Governments do about WEP and GPO?**

For those governments that are covered by Social Security, like the entities in the private sector, Social Security offset is not an issue. However, for the many governments that have chosen to opt out of Social security coverage, it is critical that they understand the rules and give the proper notices. The advisers to governments, including investment providers, TPAs, CPAs and attorneys should take the responsibility to let the government know of this potential trap for the unwary.

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