



# NYLEX News

*News and Events in the Executive Benefit Program Marketplace*

## Should Qualified Plans Be Used To Pay Nonqualified Benefits?

TO OUR CLIENTS AND FRIENDS

THIS ISSUE OF NYLEX NEWS DISCUSSES THE PROS AND CONS OF QSERPs, A TECHNIQUE SOME COMPANIES HAVE USED TO PAY NONQUALIFIED BENEFITS TO HIGHLY COMPENSATED EMPLOYEES FROM QUALIFIED PLAN ASSETS.

PLEASE SEND COMMENTS ABOUT THIS EDITION OF NYLEX NEWS, AS WELL AS SUGGESTIONS FOR FUTURE ISSUES, TO OUR STAMFORD, CT OFFICE.

### **QSERPs**

A recent article in the Wall Street Journal discussed QSERPs, a technique being utilized by some employers to increase qualified plan retirement benefits for highly paid employees beyond the normal plan formulas. This is accomplished without significantly increasing the benefits paid to non-highly paid employees. This practice has come to be known as a Qualified Supplemental Retirement Plan, or “QSERP”.

QSERPs are perceived to have four main benefits:

1. Generate a current tax deduction for additional contributions to the qualified plan.

2. Generate tax-free investment returns on the additional contributions.
3. Eliminate FICA taxes for the portion of the benefit moved into the qualified plan.
4. Enhance the benefit security for executives.

In addition to saving FICA and having enhanced benefit security, employees have the additional advantage of being able to roll over the qualified plan balance into an Individual Retirement Account upon retirement or separation from service.

### **How QSERPs Work**

To understand this technique, one must first understand the differences between qualified and nonqualified defined benefit plans. Defined benefit plans,

of course, are designed to result in a specific benefit upon retirement. Qualified plans generally must cover most or all employees, are subject to ERISA, must be nondiscriminatory, must be funded, and result in advantageous tax treatment. Nonqualified plans cover a select group of highly-compensated employees (and are therefore discriminatory by design), are exempt from much of ERISA, represent unsecured obligations of the company, and benefits are not deductible until paid.

Large employers often have both types of plans, with the nonqualified plans “making up” for the shortfall in retirement benefits created by the limits applicable to qualified plans. Those limits include a

maximum benefit and maximum compensation that can be recognized in determining plan benefits. In essence, a QSERP is an attempt to get around the qualified plan compensation limits.

At first glance, the nondiscrimination requirements of qualified plans require that benefits must accrue evenly for the highly and non-highly paid. This is not entirely accurate. What the law actually requires is that **some** of the non-highly paid employees accrue benefits at least as fast as the highly paid employees. Therefore, it is possible to comply with the nondiscrimination requirements by increasing the rate of benefit accrual for a few of the non-highly paid to keep pace with the increases given to top executives.

Large companies, especially those with a sufficient number of new or low-paid employees can use the QSERP technique to maximize the benefits provided to highly paid employees under a qualified defined benefit plan, and therefore receive the advantages described above.

### Some Concerns

The main drawbacks of the QSERP are as follows:

1. The company must have a qualified defined benefit plan.
2. The company must have a sufficiently large population of non-highly paid employees.
3. Benefits will typically vest more quickly under the qualified plan than under a nonqualified plan, so the employer loses the ability to impose "golden handcuffs" on highly paid employees.
4. Spousal consent is required if a married qualified plan participant wishes to elect a benefit form other than joint and survivor.
5. Actuarial testing has to be completed more often resulting in an increase in administrative costs.
6. Required contributions to the qualified plan will increase, unless the plan is overfunded. A nonqualified plan does not require any pre-funding, although most are informally financed.
7. Moving benefits from a nonqualified into a qualified plan could violate 409A and trigger immediate employee taxation.

### Summary

In theory, the QSERP accelerates a tax deduction, shields some investment income from tax, and leaves rank-and-file employees unchanged in the transaction. The winners are therefore the owner/shareholders, because of the tax-efficient nature of the transaction. This technique is not without risk to the rank and file employees.

In some situations increasing qualified plan liabilities can hasten the demise of a qualified plan and force the Pension Benefit Guarantee Corporation (PBGC) to take over. If this were to occur, any rank-and-file employee who does not have his entire benefit guaranteed by the PBGC suffers, as does the highly paid employee.

Many employers may conclude that the risks of the QSERP outweigh the advantages. In order for this technique to be successful, an employer must satisfy very specific mathematical tests. We are concerned that even then, the IRS may successfully overturn a company's QSERP on the basis that it violates the spirit of the nondiscrimination rules.

## About **NYLEX**Benefits

NYL Executive Benefits LLC (“NYLEX Benefits”) provides supplemental executive benefit programs to a wide range of commercial clients. We focus on developing cost effective executive benefit solutions that are designed to attract, reward and retain key employees. Our services are designed to assist clients at all stages in the adoption and operation of executive benefit programs and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

NYLEX Benefits’ professional staff includes the following professional disciplines, all

dedicated to supporting our client’s programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and cost effective and that they are designed to achieve our clients’ strategic and operational goals.

### **NYLEX**Benefits

281 Tresser Boulevard, Suite 1110  
Stamford, CT 06901  
(203) 353-5800 FAX (203) 353-5844

[www.nylexbenefits.com](http://www.nylexbenefits.com)

Nothing contained herein is, or should be construed as, legal, tax, or accounting advice, nor was it intended nor can it be used for the purpose of avoiding penalties under the Internal Revenue Code or applicable state or local tax provisions. This communication was written to support the promotion or marketing of the matters or transactions addressed herein, and clients should always consult with their independent professional advisors to seek advice on the applicability of this information to their particular circumstances.

---