A Fruit Salad By Any Other Name…

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"QSERPS" – a new idea?

After having been in the consulting business for a little over 30 years, one thing that I have learned is that no matter how many good ideas you may have—these ideas are nothing unless they can be marketed successfully. I must defer to the "big boys" on their latest marketing effort which seems to be gaining popularity with the larger employers. I refer to the QSERP—a "*Qualified* Supplemental Executive Retirement Plan".

Qualified—you say? Aren't Supplemental Executive Retirement Plans (SERPs) non-qualified by nature? After all, these plans are set up to provide selected executives with benefits which are unavailable to the regular rank and file employee. You are probably familiar with the general forms of executive compensation—plans such as "top-hat plans", or Benefit Equalization Plans (BEPs), or Excess Benefit Plans which are designed to provide selected key executives with extra benefits not provided to the common employee. These forms of deferred compensation have always been in the non-qualified form. So what is this new QSERP and how does it work?

Background

The development of the QSERP is an outgrowth of the regulations provided under Internal Revenue Code Sections 401(a)(4) and 410(b)—the general non-discrimination rules applying to qualified retirement plans. These regulations were first issued by the Internal Revenue Service in May, 1990 in proposed form. Public commentary was sought (as is normally the case with proposed regulations) and final regulations were issued in September, 1991. It took about a year for the IRS to figure out that they had made a mistake and these final regulations were subsequently withdrawn. New proposed regulations were issued again in January, 1993 and finalized (again) in August, 1993. This time the IRS has stood by its decisions and these regulations form the basis of the complex quantitative testing rules whereby a plan can be determined to be discriminatory or non-discriminatory.

So how does the testing work and why should you care? The second part of the question is easy (I'll get to it in a bit)—the first part is the more challenging to explain. But let's try.

Code Section 401(a)(4) says something like—"Thou shall not discriminate in favor of officers, shareholders and highly compensated employees." This section has been in the Internal Revenue Code for a long time but no one really knew

what it meant. The IRS always used their traditional "facts and circumstances" approach to decide on a case-by-case basis whether a plan, or a combination of plans, was discriminatory. Consultants had a pretty fair guess whether a plan design would pass muster, but there was no guaranty as the rules were subjective in nature and a plan which seemed to be OK one year could possibly cross the line to become discriminatory in a subsequent year. Guidance was required and the larger companies were the ones screaming the loudest. After all, how could a company offer a 401(k) plan to one division and a defined benefit plan to another division; or a different retirement program to hourly employees and salary employees; or extra retirement benefits to the employees of the parent company but not to the employees of the subsidiary; if they couldn't be sure whether or not they were providing non-discriminatory benefits? Regulatory guidance was in the form of general revenue rulings and private letter rulings, but no firm regulations.

Lets sit down to lunch

The IRS, heeding the call, devised some complicated mathematical testing procedures with a very bright line result. I like to think of it as making a fruit salad. First you divide your testing group into highly compensated employees (HCEs) and non-highly compensated employees (NHCEs). The general classification for HCEs are owners and employees who make more than $80,000 ($85,000 beginning in Y2K). There are some exceptions for larger companies who have lots of employees above the compensation limit but that is of no import. Once the groups are separated, they are tested to determine whether the plan (or plans) provide measurably greater benefits for the HCEs. It is important to understand that discrimination can only occur ***between*** the two groups. A plan which provides differing benefits among NHCEs cannot be discriminatory—and a plan which provides differing benefits among HCEs cannot be discriminatory. Discrimination can only occur between HCEs and NHCEs.

Once you have divided your groups, you can compare apples to oranges by converting everything to grapefruits. A certain benefit (say a 401(k) match)—lets call it an "apple" is worth some number of grapefruits to an employee. Another benefit (say an annual accrual in a defined benefit plan)—let's call it an "orange" is worth some other number of grapefruits to an employee. If we convert all of our apples and oranges to grapefruits on an employee-by-employee basis and verify that the NHCEs have more grapefruits than the HCEs, then the plan or plans when tested together are deemed non-discriminatory. Simple fruit salad mathematics!

The art of retirement plan design changed dramatically once consultants began to understand the power of the IRS regulations. You see, although, the final testing is done by comparing grapefruits to grapefruits—the IRS permits you to change the apples first to plums or kumquats and then slice up a few and recombine them and maybe make a sauce or a juice, and finally get back to

grapefruits before you test—so what seems to be a simple grapefruit to grapefruit test has so many intermediate possible favorable outcomes that the tests are seldom failed.

These plan designs operate under a number of different names. Terms such as "cross tested plans", "class plans", "tiered plans", and "general tested plans" are all used to describe the possible arrangements using the IRS non-discrimination regulations.

The consultants to the small plan marketplace were the first to apply these new rules. Look at this Profit Sharing plan which I just designed for a small medical group.

XYZ Medical Corporation

Position	**Age**	**Salary**	**Contribution**
Physician	47	$160,000	$30,000
Nurse	31	50,000	2,500
Technician	30	30,000	1,500
Receptionist	22	20,000	1,000
TOTAL		**$260,000**	**$35,000**

The physician receives !8.75% of pay and the rank and file employees receive 5% of pay. Discriminatory?? Not according to the regulations. More grapefruits to the rank and file employees than to the physician.

Law firms were next to hop onto the band wagon of these "general tested plans". The typical law firm provides a defined benefit plan to the partners and non-lawyers and a 401(k) plan for the associates in the firm. The 401(k) plan generally does not include a match although sometimes there is a small employer provided match contribution. The defined benefit plan provides differing levels of benefits to each partner (remember, there cannot be discrimination present *among* HCEs) and a minimal level of benefits to the non-lawyers. Often there is a defined contribution pension plan at about 3% of pay to the non-lawyer employees and sometimes a higher contribution to the paraprofessionals than to the regular office staff. The office manager might receive a still larger contribution—(no discrimination *among* NHCEs). The 401(k) plan may also be offered to the non-lawyer staff. Discriminatory?? Not usually. Fruit salad aside, the NHCEs have more grapefruits than the HCEs.

A buffet lunch for all

After a few years, the “big boys” finally caught on. Sure they can have their cash balance plans and their life cycle plans for the employee group [by the way, these plans also use these same IRS regulations to prove that they are non-discriminatory!]; but what can they do for the executives? Why, let’s give the executives a bigger benefit or a bigger contribution than everyone else (more apples) and test it against the other employees to see who has the most grapefruits. I know—we can call it a QSERP and market the devil out of it!…