

Q-SERPs

How Companies Manipulate the Law to Fund Executive Pay Packages with Workers' Pension Money

On August 4, the *Wall Street Journal* exposed an unethical practice in which companies use pension plans that are set up for their rank-and-file workers to finance extravagant retirement benefits for a small number of high-paid executives.¹ This practice is a clear manipulation of federal tax and pension laws, allowing companies to exploit tax breaks that are intended for the pensions of regular employees and instead use them to pay for executives' pensions. These benefits are known as Qualified Supplemental Executive Retirement Plans or Q-SERPs.

Why are some companies using pension plans to pay executive benefits?

Under current law, rank-and-file pension plans receive special tax treatment as long as the plan meets certain standards. To get these tax breaks, pension plans must meet nondiscrimination rules that prohibit them from discriminating in favor of highly-paid employees. These pension plans are called "**qualified plans**" because they qualify for tax breaks.

In order to meet the nondiscrimination rules, the amount of benefits that executives pay themselves out of the qualified plan has to be tied to the amounts paid to regular employees. The benefits can be unequal, but the difference between what the high-paid and lower-paid receive cannot be too wide, or else the plans will flunk the discrimination tests.

However, the executives are also allowed to pay themselves extremely generous benefits through separate Supplemental Executive Retirement Plans (SERPs). These plans, unlike qualified pension plans, are allowed to include only high-income workers and provide unlimited benefits to corporate officers. The catch is that these extra benefits will be paid out of corporate revenues when they retire, not out of a pension fund. Because they do not qualify for tax subsidies, these SERPs are "**nonqualified plans.**"

¹ "Companies Tap Pension Plans To Fund Executive Benefits," by Ellen Schultz and Theo Francis. *Wall Street Journal*, August 4, 2008, p. 1.

In the past decade, high-paid consultants have figured out a way to circumvent the carefully-constructed “nondiscrimination” laws of pension plans, in order to greatly increase the pensions executives could get from the qualified plans established for the general workforce. They devised a new product called Qualified Supplemental Executive Retirement Plans (Q-SERPs), which allow companies to do an end-run around existing laws and pay special benefits to executives out of the funded tax-advantaged qualified plan.

In a marketing document on Q-SERPs, consulting firm Watson Wyatt writes that these benefits have several advantages over traditional executive benefit arrangements because “the plan sponsor can prefund the benefits on a tax-favored basis; the executive incurs no tax liability until benefits are distributed; when benefits are distributed, tax saving options, such as IRA rollovers, may be available; and benefits provided via a qualified plan are much more secure than those offered via typical unfunded arrangements.”²

In other words, consulting firms boast that they have created a scheme that can make the rich richer, and scam the Internal Revenue Service – at the expense of all taxpayers who foot the bill for pension tax breaks.

How do Q-SERPs work?

The Q-SERP can be viewed as a new smaller qualified plan that is established within the larger already-existing qualified pension plan. The company continues to provide pensions to its employees, but then uses this smaller plan to pay special benefits to certain executives.

Here’s how it works. The company first identifies executives to whom it wishes to pay extra benefits through the Q-SERP. It cannot simply award the executives bigger benefits, because the discrimination rules say that increased benefits for highly paid employees have to meet complex mathematical tests to make sure that the higher benefit levels filter down to working people who are not highly paid.

But when companies apply these mathematical tests to show they are not discriminating, they do not have to look at all, or even most, employees. This is where the benefits consultants come in: using complex software, the consultants “slice and dice” the workforce into hypothetical subgroups, some of which include a token number of lower-income employees, along with executives. The company then amends

² <http://online.wsj.com/public/resources/documents/watsonwyatt-ceofund-01102007.pdf>

the plan to give these selected lower-income and high-paid executives increases in their benefits. By pairing the lower-income employees with the high-income executives, it is able to award substantially larger pensions to select executives and technically satisfy the IRS's nondiscrimination rules.

This practice can enable some top executives to award themselves extra tax-favored, protected pensions worth more than \$100,000 a year for life, while leaving the low-paid employees very little in additional benefits. In some cases, the lower-paid employees may not remain on the job long enough to earn a pension.

The *Wall Street Journal* cites the example of Royal and SunAlliance, which set up a Q-SERP to award eight officers generous new benefits before the company sold a division and laid off employees. According to the article, "one human-resources executive got an additional \$5,270 a month for life." To do this and still pass the IRS' nondiscrimination tests, "[t]he company needed to give tiny pension increases to 100 lower-level workers...One got an increase of \$1.92 a month."

This ruse also can allow companies to transfer its IOUs for executive benefits into the pension plan. By doing this, the company can take a deduction for the executive's benefits, and use pension money set aside for regular retirees, instead of tapping corporate coffers.

This process is arbitrary and unfair – and makes a mockery of the tax laws that are meant to protect lower-paid workers.

Do Q-SERPs violate the law?

Q-SERPs were designed by consultants to technically conform to Internal Revenue Code non-discrimination rules that were originally designed to provide protections for lower-paid employees in small companies. They were never intended to allow executives of large companies to provide themselves larger tax-favored guaranteed benefits. This manipulation of the tax laws is both legally and ethically problematic. The practice should be stopped. In addition, there are aspects of the Q-SERPs which appear to violate provisions of tax and pension laws that require pension plans to operate solely in the interests of workers and retirees.

Why do Q-SERPs pose a risk to employees and retirees?

Q-SERPs can contribute to the failure of pension plans. When companies add Q-SERPs, they shift liabilities for the executives into the plans, which can make the plans become

less well-funded. The *Wall Street Journal* article discussed two financially troubled companies that transferred executive pensions into their already underfunded pension plans, which contributed to the plans' failure, causing employees to lose some of their pension benefits. This ultimately further stretches the resources of the federal private pension insurance program, the Pension Benefit Guaranty Corporation.

Another risk to employees is the fact that the Q-SERP loophole gives companies an incentive to freeze the pensions for rank-and-file workers. Freezing a plan stops workers from building any additional benefits even though they continue to work, which means there will be more money in the pension plan available to pay Q-SERP benefits to executives.

Similarly, Q-SERPs also reduce the possibility that surplus assets will be used to increase regular employees' benefits or provide cost of living adjustments to retirees. The idea that multi-millionaire executives can use employee pension money to spike their own benefits while freezing the benefits of other employees is grossly unfair.

What are the solutions?

Most of the loopholes that enable consultants to create Q-SERPs were created by the Department of Treasury in their regulations on non-discrimination. These regulations should be revised or overturned by legislation to end Q-SERP abuses. The easiest solution would be to limit plans to only one benefit structure for a company's employees, with limited exceptions, for example, in the case of mergers or acquisitions.

September 2008