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United States Government Accountability Office  
Washington, DC 20548

May 12, 2011

The Honorable Sander Levin  
Ranking Member  
Committee on Ways and Means  
House of Representatives

The Honorable Richard Neal  
Ranking Member  
Subcommittee on Select Revenue Measures  
Committee on Ways and Means  
House of Representatives

The Honorable Lloyd Doggett  
Member  
Committee on Ways and Means  
House of Representatives

*Subject: Private Pensions: Little Information Available on Qualified  
Supplemental Executive Retirement Plans*

On March 28, 2011, we briefed your staffs on the results of our work. This report formally conveys the information provided at that briefing.

To raise private savings for workers' retirement, federal law provides tax incentives for contributions to pension plans. Company sponsors of private defined benefit (DB) pension plans can claim a tax deduction for their contribution amount to a tax-qualified pension plan, and employees' taxes on contributions and investment earnings are deferred until they retire and start receiving benefit payments.<sup>1</sup> In fiscal year 2011, tax expenditures for DB pension plans will total almost \$52 billion in estimated federal income tax revenue losses according to the Joint Committee on Taxation.<sup>2</sup> These tax incentives are structured to strike a balance between

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<sup>1</sup>A DB plan is a qualified plan where the plan sponsor provides a guaranteed benefit generally expressed as a monthly benefit based on a formula that generally combines salary and years of service to the company.

<sup>2</sup>This estimate reflects tax laws in effect through December 15, 2010. The tax expenditure is measured as the income tax revenue that the government does not currently collect on contributions and earnings amounts, offset by the taxes paid on pensions by those who are currently receiving retirement benefits.

encouraging employers to start and maintain voluntary, tax-qualified pension plans and ensuring that employees receive an equitable share of the tax subsidized benefits.

To achieve and maintain tax-qualified status, DB plans must comply with multiple federal requirements that are designed to ensure that executives and other highly compensated employees (HCE) do not receive excessively high benefits, both in an absolute sense and relative to nonhighly compensated employees (NHCE).<sup>3</sup> These include limits on total benefit levels, limits on the amount of compensation that can be included in determining benefit levels, and limits on disparities in benefits between HCEs and NHCEs. For instance, the Internal Revenue Code (IRC) places a limit of \$195,000 on the annual benefit that an individual can receive from a tax-qualified pension plan beginning at age 62. In addition, it sets a limit of \$245,000 on the amount of annual compensation that can be used in calculating the benefit amount. Third, the IRC and Internal Revenue Service (IRS) regulations require that benefits in a tax-qualified plan not discriminate significantly in favor of HCEs in terms of coverage and benefit amounts (the “nondiscrimination requirements”).

The goal of the nondiscrimination requirements is to encourage expanded coverage and greater distribution of benefits between the highly paid and workers at lower earnings levels. To demonstrate compliance, plan sponsors may use an IRS preapproved plan or develop a customized plan, which must pass general nondiscrimination tests.<sup>4</sup> These tests generally require a plan sponsor to perform mathematical calculations that compare the proportion of NHCEs who benefit under a tax-qualified plan with the proportion of HCEs who benefit, taking into account their respective benefit accrual rates.<sup>5</sup> Pursuant to IRS regulations, the timing of plan amendments must also be nondiscriminatory. A plan sponsor can, but is not required to, request a determination letter from IRS confirming that the level of benefits under the plan meets the regulatory standards relating to benefit accrual rates. To obtain IRS review of whether a plan amendment is nondiscriminatory, the plan sponsor must demonstrate compliance with objective requirements by providing specific demonstrations in the determination letter request filed with IRS.

Due to the restrictions placed on benefits in a tax-qualified plan, some private sponsors of tax-qualified retirement plans provide additional nontax-qualified supplemental retirement benefits to certain HCEs as part of the HCE’s total compensation. These benefits do not enjoy the tax advantages conferred upon qualified plans. In addition, any assets backing these benefits generally remain company assets and, depending on the funding arrangement, could be withdrawn

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<sup>3</sup>For 2011, the IRC defines an HCE as an employee who earns in excess of \$110,000 per year.

<sup>4</sup>IRS preapproved plans generally provide uniform benefits to all employees.

<sup>5</sup>For example, to demonstrate that a plan is nondiscriminatory in terms of employee coverage, a plan sponsor can use the “ratio test” to demonstrate that the percentage of NHCEs who benefit under a plan is at least 70 percent of the percentage of HCEs who benefit under the plan.

by the sponsor or made available to creditors in the case of a sponsor bankruptcy.<sup>6</sup> Utilizing flexibilities in the nondiscrimination rules, some plan sponsors have designed ways to indirectly transfer some of these nontax-qualified supplemental executive benefits into their existing tax-qualified DB plans. In effect, plans accomplish this by increasing the benefits under the qualified plan, with an offsetting reduction in the benefits under the nonqualified plan, which extends to the HCE the security of DB plan funding and the tax benefits of a qualified plan. These arrangements, commonly referred to as Qualified Supplemental Executive Retirement Plans (QSERP), can provide HCEs with a higher qualified benefit amount, the tax advantages provided by a qualified plan, as well as the increased benefit security provided by the backing of qualified plan assets.<sup>7</sup> Since QSERPs are provided to HCEs, but are funded by the assets used to pay qualified plan benefits for all employees, some observers have questioned whether these arrangements affect the benefits promised to NHCEs. To the extent that the share of benefits to HCEs was maximized, NHCEs' benefits would represent a smaller proportion of the accrued benefits under the company's qualified plan. However, a few experts maintain that increasing some HCEs' tax-qualified benefits could give HCEs and plan decision makers a larger stake in continuing the DB plan and in keeping it adequately funded.

In this context, you asked us to examine several aspects of QSERP arrangements. To respond to your request, this report addresses (1) what is known about the prevalence and design of QSERP arrangements and to what extent recent economic conditions have influenced plan sponsors implementing these arrangements; (2) the key regulatory and statutory issues associated with these arrangements; and (3) the implications of these arrangements for involved parties, including the Pension Benefit Guaranty Corporation (PBGC).<sup>8</sup>

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<sup>6</sup>Special restrictions apply under 26 U.S.C. § 409A(b).

<sup>7</sup>According to a Department of the Treasury official, QSERP techniques are one of a variety of analytical techniques (e.g., involving statistical modeling) that can be applied to plan-specific data. Depending on the content of such data, such techniques may identify discrete opportunities to enhance HCE benefits that, in turn, are reflected in the plan by an amendment increasing benefits. Thus, while an employer cannot directly transfer nonqualified deferred compensation liability to a qualified plan, various steps can be taken that indirectly have that effect. For example, if the terms of the nonqualified deferred compensation arrangement provide for that compensation to be reduced by the value of the benefit provided by the qualified plan, that effect could result from a benefit increase in the qualified plan, which might range from an increase for named individuals or a specified class of employees (i.e., salaried workers at a specified location)—where the increase takes advantage of the room available to the plan under the general nondiscrimination in benefits testing—to an across-the-board increase in benefits for all participants. Further, the benefit increase might be accompanied by an independent change in benefits to improve nondiscrimination testing results. In addition to the limits set forth under the nondiscrimination rules, the IRC limits on annual benefits and annual compensation constrain the amount of allowable benefit increase.

<sup>8</sup>PBGC is a federal corporation that insures the pension benefits of participants in qualified DB pension plans. PBGC takes over terminated plans that have insufficient assets to pay the benefits promised to employees and is responsible for paying those benefits up to certain limits set by law. For 2011, the maximum annual benefit amount is \$54,000 for workers who begin receiving payments from PBGC at age 65.

## Scope and Methodology

For the purposes of our review, we focused exclusively on QSERP arrangements. To conduct this work, we reviewed relevant federal laws and regulations; conducted a comprehensive review of available literature on plan designs; and interviewed professional pension experts, consultants, and cognizant federal officials.

We conducted our work from November 2010 to May 2011 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.

## Key Findings

- The prevalence of QSERPs is unknown because comprehensive data are not available, and we were unable to identify sufficient experts with broad quantitative information on QSERP arrangements. IRS maintains a database that tracks plan sponsors' requests for an IRS determination on the acceptability of pension plan amendments, but it does not capture data to allow for the systematic identification of amendments that have the effect of transferring nontax-qualified benefits into their existing tax-qualified DB plans. We were unable to identify any other private or public data on the prevalence of QSERPs. In addition, there was little qualitative information on their prevalence or design. We found no academic or related literature on the prevalence or design of QSERPs. While many of the pension experts we interviewed were familiar with QSERPs, some stated that they did not possess sufficient specialized knowledge about the prevalence or design of these arrangements.
- Recent economic conditions, which contributed to a decline in the overall funding of many plans, may have made the implementation of new QSERP arrangements less likely.<sup>9</sup> However, given the lack of data on QSERPs, we cannot confirm whether the number of QSERPs changed in response to the economic downturn. It is possible that plan sponsors could introduce new QSERPs in the future as the ratio of plan assets to plan liabilities improves, but

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<sup>9</sup> Experts indicated that QSERPs were likely more prevalent before the economic downturn when plan sponsors implemented QSERPs to make use of surplus funds. While the likelihood of new QSERP arrangements may have decreased, QSERP arrangements that were implemented in the past are likely still in force. Moreover, in the past, there were fewer restrictions to prevent plan sponsors from adding QSERP arrangements to underfunded plans.

the current pension plan funding requirements of the Pension Protection Act of 2006 (PPA) place limits on the addition of new liabilities to a tax-qualified plan.<sup>10</sup>

- QSERPs are one of a variety of arrangements that plan sponsors may use to provide additional qualified benefits to HCEs within the constraints of the nondiscrimination rules.
- Potential QSERP implications may in some instances include a reduced federal income tax liability for plan sponsors and a higher and more secure qualified benefit amount for HCEs. Any effect on the benefit security of NHCEs is uncertain. PPA requirements reduce the likelihood that a QSERP could be added to a plan that did not have sufficient funding to pay promised benefits. It is uncertain what effect, if any, a QSERP arrangement would have on PBGC.<sup>11</sup>

### Agency Comments

We provided copies of this draft report to the Secretary of the Treasury, Secretary of Labor, IRS Commissioner, and PBGC Director for review and comment. Each of the agencies provided technical comments, which we incorporated into the draft, as appropriate.

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As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the appropriate congressional committees and other interested parties. The report also will be available at no charge on the GAO Web site at <http://www.gao.gov>.

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<sup>10</sup>PPA prohibits a plan sponsor from putting amendments into effect that add new liabilities to a plan that is not at least 80 percent funded (after taking the amendment into account) unless the sponsor makes additional contributions to the plan. Also, PPA requires plan sponsors to amortize any unfunded liabilities that are added to a plan over a 7-year period. Prior to PPA, such liabilities could be amortized over longer periods and, as a result, sponsors could amend their plans to increase HCE benefits through a QSERP arrangement without regard to the amendment's potential effect on the plan's long-term viability.

<sup>11</sup>The financial effects of a QSERP arrangement can create some atypical benefit outcomes given PBGC rules governing benefit payouts. For example, by law PBGC must allocate plan assets in accordance with priority categories. These categories require PBGC to pay benefits above the guaranteed limit to a participant that retired or became eligible for retirement within 3 years of plan termination. Thus, it is possible that an HCE would receive benefits in excess of the PBGC limits, while active NHCE employees ineligible for retirement would not. Specifically, if plan assets were insufficient to cover all plan benefits, and the plan had been amended to include a QSERP at least 5 years prior to termination, a retired HCE with a QSERP might receive benefits in excess of the guarantee, while NHCEs and HCEs whose benefits were above the PBGC guarantee limit and who are not retirement eligible would not.

If you or your staff members have any questions about this report, please contact me at (202) 512-7215 or [jeszeck@gao.gov](mailto:jeszeck@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. The following GAO staff members made key contributions to this report: David Lehrer, Jonathan McMurray, Sherwin Chapman, and Chad Williams contributed to all aspects of this report; Roger Thomas provided legal support; Frank Todisco provided actuarial support; and David Chrisinger assisted with report development.

A handwritten signature in black ink, reading "Charles Jeszeck". The signature is fluid and cursive, with the first letters of each word being capitalized and prominent.

Charles Jeszeck  
Director, Education, Workforce,  
and Income Security Issues

Enclosure

**Briefing Slides**

Enclosure: Briefing Slides



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# **Qualified Supplemental Executive Retirement Plans**

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**Briefing for Congressional Staff  
Committee on Ways and Means  
House of Representatives**

March 28, 2011

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For more information, contact Charles Jeszeck, [jeszeck@gao.gov](mailto:jeszeck@gao.gov).

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## Background

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- To promote retirement savings, federal law provides tax incentives for pension contributions and earnings.
- Private firms can claim a tax deduction for contributions made to pension plans.
- Employees are not required to pay taxes on benefits until receipt.
- The Joint Committee on Taxation estimates that tax expenditures for contributions to defined benefit (DB) pension plans and their associated earnings will total almost \$52 billion in fiscal year 2011.
- The Pension Benefit Guaranty Corporation (PBGC) insures participant benefits in qualified single-employer DB plans up to a maximum guarantee amount of \$54,000 (in 2011) per year for a retiree at age 65.



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## Background (cont'd)

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- The Internal Revenue Code (IRC) contains provisions designed to limit tax-deferred benefits available to highly compensated employees (HCE) in a qualified plan.
- For example, the IRC
  - limits the amount of annual compensation that can be used to calculate the benefit amount (\$245,000 in 2011), and
  - limits individual annual qualified pension plan benefits (\$195,000 in 2011).



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## Background (cont'd)

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- Under IRC and Internal Revenue Service (IRS) regulations, qualified defined benefit plans must not significantly discriminate in favor of HCEs.
  
- Specifically, an employer must
  - make plan benefits available in a nondiscriminatory manner,
  - not discriminate in plan benefit amounts, and
  - not discriminate when amending a plan.
  
- IRS has specific tests for each of these three types of discrimination that employers can use to demonstrate that a plan is nondiscriminatory.



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## What is a 'QSERP?'

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- To increase executive retirement benefit amounts beyond the IRC limitations, some private sponsors of qualified retirement plans provide additional nonqualified supplemental benefits to HCEs in what are called Supplemental Executive Retirement Plans (SERP). These benefits do not enjoy the tax advantages conferred upon qualified plans. In addition, any assets backing these benefits remain company assets and, depending on the funding arrangement, could be withdrawn or made available to creditors in the case of a sponsor bankruptcy.
- Using flexibilities in nondiscrimination testing, some plan sponsors have increased the benefits under the qualified plan, with an offsetting reduction in the benefits under the nonqualified plan, to make use of plan surplus funds and realize additional tax benefits.
- These arrangements, commonly referred to as Qualified Supplemental Executive Retirement Plans (QSERP), are generally associated with large defined benefit plans, but small plans also employ similar arrangements.



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## Research Questions

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- (Q1) What is known about the prevalence and design of QSERP arrangements and to what extent have recent economic conditions influenced plan sponsors implementing these arrangements?
- (Q2) What are the key regulatory and statutory issues associated with these arrangements?
- (Q3) What are the implications of these arrangements for involved parties, including PBGC?



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## Methodology: General Approach

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- Reviewed relevant federal laws and regulations.
- Reviewed available literature on plan designs but did not review any individual DB plan designs.
- Identified and interviewed
  - professional pension experts,
  - consultants and practitioners, and
  - cognizant federal officials.



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## Methodology: Data and Related Limitations

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- Comprehensive quantitative data on the prevalence or design of QSERP arrangements in the U.S. private pension system are not available.
- While IRS maintains a database that tracks plan sponsors' voluntary requests for an IRS determination on the acceptability of pension plan amendments, the database does not capture data on amendments specific to QSERPs.
- After consulting with experts, we were unable to identify or locate any other private or public sector data on the prevalence or design of these arrangements.



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## Methodology: Data and Related Limitations (cont'd)

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- We interviewed 21 pension experts and consultants and conducted a comprehensive review of academic pension literature and found that
  - there were few experts on QSERP arrangements, and
  - research on QSERP arrangements was not extensive.
- We are conducting this work in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.



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## Q1: QSERP Prevalence and Design

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- The overall prevalence of QSERP arrangements is unknown.
- Recent economic conditions, which contributed to decline in the overall funding of many plans, may have made the implementation of new QSERP arrangements less likely.
- Other factors, such as current funding requirements, may make it less likely that the number of QSERP arrangements will increase as economic conditions improve.



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## Q1: QSERP Prevalence and Design (cont'd)

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Plan sponsors employ numerous techniques to pass the nondiscrimination tests while providing additional qualified benefits to HCEs. These techniques can include

- treating defined contribution plans as DB plans,
- using different methods to value benefits,
- grouping of employees, and
- aggregating or disaggregating plans.



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## Q2: Key Regulatory and Statutory Issues

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- Plans cannot discriminate significantly in favor of HCEs in terms of coverage or benefit amounts.
- Plans may use either a nondiscriminatory safe harbor/preapproved plan or an individually designed plan, which must pass general nondiscrimination tests.
- Nondiscrimination testing offers flexibility in how to demonstrate compliance with this requirement.
- The timing of all plan amendments, including QSERP arrangements, must be deemed nondiscriminatory by IRS on a “facts and circumstances” basis.



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## Q3: Implications of QSERP for Involved Parties

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- Plan sponsors may have a reduced federal income tax liability and could make use of any plan overfunding.
- HCEs would have a more secure benefit, a greater qualified benefit amount, and a larger stake in the DB plan.
- Any effect on the benefit security of NHCEs is uncertain.
- It is also uncertain what effect, if any, a QSERP arrangement would have on PBGC.



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## Concluding Observations

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- Little is known about the prevalence and design of QSERP arrangements because there is a lack of data and few experts.
  - As a result, we cannot estimate
    - the number or proportion of DB plans that have utilized these arrangements,
    - the amount of money invested in them, or
    - the extent to which recent economic conditions have influenced their use.
- IRS cannot identify requests for determinations that explicitly pertain to QSERP amendments.



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## Concluding Observations (cont'd)

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- GAO can only report the statements and opinions of a selective sample of pension experts and practitioners who were recommended to GAO and willing to be interviewed.
- Their statements and opinions may not be independent or represent the spectrum of opinions regarding QSERP arrangements.
- GAO cannot evaluate the accuracy or validity of these experts' views or whether the potential QSERP designs they discussed are legally valid, used frequently, or represent the range of techniques available to plans.

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Ralph Dawn, Managing Director, [dawnr@gao.gov](mailto:dawnr@gao.gov), (202) 512-4400  
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Chuck Young, Managing Director, [youngc1@gao.gov](mailto:youngc1@gao.gov), (202) 512-4800  
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