



Supplemental Executive Retirement Plan (SERP)



NATIONAL BENEFITS GROUP
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Supplemental Executive Retirement Plans (SERP) Guide

What is a Supplemental Executive Retirement Plan (SERP)?

A supplemental executive retirement plan is a deferred compensation agreement between a company and its key executive(s). The company agrees to provide supplemental retirement income to the executive and his or her family if certain pre-agreed upon conditions are met by the executive. The company makes annual contributions to the employee retirement accounts, though some SERP plans may allow the employees to make additional contributions to their accounts as well. Plan benefits, when paid, are funded by the company out of cash flows, investment funds or cash value life insurance. Any deferred account balances are not currently taxable to the key executive. When paid, the benefits become taxable to the executive as income and tax deductible to the company. The employer may impose a vesting schedule, also known as “golden handcuffs,” to incentivize the executive to stay with the company.

Who may be interested in a SERP?

Executives who may:

- Have maximized their qualified plan contributions
- Want supplemental retirement income
- Want to defer paying taxes on income they currently don't need*

Businesses wanting to:

- Develop an executive retention strategy
- Provide substantial benefits to its key executives
- Accommodate for being top heavy

Advantages of SERPs

FOR EXECUTIVES

- May allow an executive to accumulate retirement income in excess of what can be accumulated in the business' qualified plans
- Avoids “reverse discrimination”
- Retirement income accumulates without current taxation
- Can be custom designed to meet individual needs
- Benefit payments may continue to be paid to the employee's beneficiaries after the employee's death
- Replaces employee benefits lost by leaving a previous employer

FOR EMPLOYERS

- Helps a business to attract and retain key executives
- Can provide benefits to selected employees
- May include vesting requirements
- Benefits are paid with tax-deductible dollars
- May allow corporate cost recovery
- Minimal Employee Retirement Income Security Act (ERISA) requirements and other government benefit restrictions are avoided
- Plan is simple to design and administration costs are low

*SERP tends to be a company funded plan, but can include deferred employer contributions to avoid taxes.

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How it Works

1. Executive enters into an agreement with the employer, whereby the employer promises to provide future income for the executive. The agreement will clearly explain the various distribution provisions (e.g., retirement, death, etc.) and whether a vesting schedule will be applied to the promised benefit.
2. The employer will create an accounting entry in its financial statements which represents the executive's account balance. The executive's account is an unsecured promise by the employer to pay the executive a future benefit.
3. Many employers choose to purchase a life insurance policy on the executive's life, naming itself owner and beneficiary of the policy. The policy is a bookable asset to the employer and may offer tax deferred growth, as well as death benefit protection. Please note that the life insurance policy is not the plan; it is merely an informal funding vehicle utilized by the employer to accumulate the funds necessary to pay the benefits due under the plan. The executive must provide written consent on the life insurance coverage.
4. At executive's retirement, the executive receives compensation paid by the employer. If life insurance was used, payments can be made via tax-free distributions of the cash value accumulated within the life insurance policy. The payments from the plan will be taxable income for the executive and tax deductible for the employer.
5. In the event of the executive's death, the employer will use the death benefit to pay the executive's heirs the remainder due. Any excess can be used as the employer wishes.

Comparison of a Pension Plan and a Supplemental Executive Retirement Plan

FEATURES	PENSION	SERP
Contribution Limits	Yes	No
Actuarial & Administrative Costs	Yes	No
Funding Requirements	Yes	No
ERISA Protection	Yes	No

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Comparison of Defined Contribution and Defined Benefit Plan

Defined Contribution SERP

In a defined contribution plan, funds are set aside today and accumulate interest. At the employee's retirement, the total value of the employee's account balance SERP fund is paid out as stated in the terms of the agreement. (Funds and any remaining employee account balances that have not been paid out may continue to accumulate interest.)

Defined Benefit Plan SERP

The amount of the benefit is defined in the agreement, but the employer's annual contribution is dependent on the discount rate associated with the benefit account.

	Defined Benefit SERP	Defined Contribution SERP
Summary	Provides benefits for death, retirement, and/or disability to employees and beneficiaries	Provides benefits for death, retirement, and/or disability to employees and beneficiaries. Provides employee the opportunity to defer current income with tax deferred growth
Structure	Similar to a traditional pension plan in which the employer provides a specific benefit at the participant's retirement based on an established formula (percentage of final salary, for example)	Similar to a profit sharing plan or an employer contributed 401(k) plan in which the employer makes contributions based on an established formula or on a discretionary basis
Benefit Contributions	100% Employer Contribution	Employer or employee contributions
Benefit Crediting Rate	Fixed rate to achieve the targeted benefit	Fixed or other trackable rate mechanism such as equities, federal rates or company stock
Benefit Flexibility	Plan can be custom-designed to meet each employee's individual needs	Plan can be custom-designed to meet each employee's individual needs
Benefit Limits	None	None

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	Defined Benefit SERP	Defined Contribution SERP
Benefit Payment	Traditionally a known amount with a level payment structured over any number of years	Amount may or may not be known as the payments are based on the account balance, at the time of retirement, paid over any number of years
Benefit Security	Employees are general creditors of company	Employees are general creditors of company
Control of Plan	Employer	Employer
Cost Recovery	Yes, if the plan is funded with life insurance via death benefits	Yes, if the plan is funded with life insurance via death benefits
Employee Benefit Taxation	Benefits taxed when paid	Benefits taxed when paid
Employer Tax Deductibility	Deductible when benefits are paid	Deductible when benefits are paid
ERISA Requirements	Minimal	Minimal
Insurance Funding	Optional, employer owns cash value and death benefit	Optional, employer owns cash value and death benefit
Income Tax-Free Survivor Benefits	No, unless the plan is funded with life insurance and the company endorses part of its death benefit to the Participant's named beneficiary	No, unless the plan is funded with life insurance and the company endorses part of its death benefit to the Participant's named beneficiary
Vesting	Based on employer schedule	Employer contributions based on employer schedule (separate vesting schedule can be included for each employer contribution). Employee contributions are based on limitations imposed by the employer but are always 100% vested

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Frequently Asked Questions (FAQs)

How is Life Insurance Used in a SERP?

- Employer sets aside funds annually into a sinking fund to pay deferred compensation benefits
- Employer uses those amounts to make premium payments into cash value life insurance
- Employer is the owner and beneficiary of the insurance policies
- Funds accumulate tax-deferred in life insurance
- Tax-free distributions from life insurance cash values may be used to pay benefits
- Employer receives insurance benefit tax free at employee's death
- Employer recovers all outlays:
 - o Premium payments
 - o Retirement benefits
 - o Corporate cost of money

Is There a Minimum Number of Employees Required in a SERP?

No. Nonqualified plans are not subject to the participation requirements typically associated with traditional qualified retirement plans. There is no minimum number of employees. The employer has complete discretion in determining eligibility for the plan.

Is There a Maximum Number of Employees Required in a SERP?

Participation will usually be limited to highly paid employees whose earnings are subject to top marginal income tax rates.

Are There Complex Reporting and Disclosure Requirements Associated With SERP?

Not necessarily; the Department of Labor requires a letter with plan identification information when the plan is established. NBG will provide a sample letter to use. Public companies may have additional proxy disclosure requirements for named officers.

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Can an Employer Use a Trust to Help Secure Its Promise to Pay Deferred Compensation Benefits in the Future?

Yes. The employer can establish a trust and deposit employee deferrals in accordance with the provisions of the trust. The trust then purchases life insurance to fund the deferred compensation benefits. Funds are held by the trustee for the benefit of plan participants.

How are Funds Placed in the Trust Treated by the Employer for Tax Purposes?

Amounts contributed to the trust are not deductible by the employer until they are subject to taxation for the employee. Usually this occurs when retirement payments begin. The trust is generally structured as a “grantor” trust so that all taxable income and/or tax deductions generated by the trust are attributed to the employer. Any interest or investment income on trust assets is taxable to the corporation. If life insurance is used, the tax deferral associated with life insurance generally eliminates corporate taxes on trust income.

Additional Considerations:

EXECUTIVE:

- The distributions from the SERP will be considered taxable income
- If the SERP provides a survivor benefit, the executive’s SERP account balance will be included in his or her taxable estate
- The executive’s SERP account balance will be subject to employment taxes (FICA and FUTA) when the plan is no longer subject to a substantial risk of forfeiture*

BUSINESS:

- Most SERPs are subject to the requirements of IRC Section 409A. Failure to meet the requirements of IRC Section 409A will result in substantial tax-penalties for the executive/participants
- The distributions from the SERP may be tax-deductible for the business
- There are no legal limits on the vesting schedule that may be placed on the executive’s SERP benefits
- The SERP must be offered to a select group of highly compensated executives

* Employer and employee taxes upon deferral vary based on the 457 Contribution Limits and Code SEC 409A set by the IRS.

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