

Concept Profile

SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN (SERP)

Retain, Reward, and Recruit Key Employees

In today's competitive job market, a company's retirement benefits package might make the difference in attracting and retaining key employees. However, a qualified plan is only one piece of the benefits puzzle. A qualified plan, such as a 401(k), has rules and restrictions prohibiting "highly compensated" executives from saving as much as they may want to be financially secure in retirement. Employers can make up this difference by offering a non-qualified deferred compensation plan, such as a Supplemental Executive Retirement Plan (SERP).

WHAT IS A SERP?

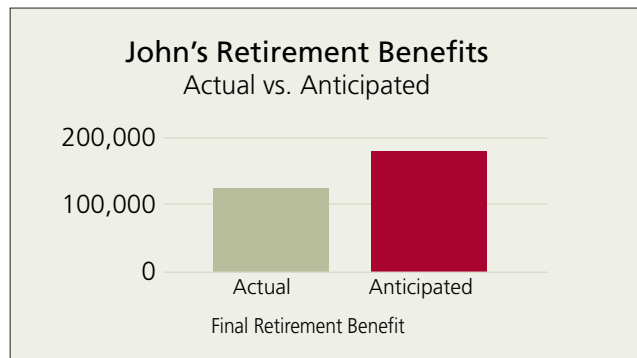
A SERP is a non-qualified deferred compensation plan that allows employers to provide retirement benefits to key employees beyond those provided by the qualified plan. It is an effective way for an employer to supplement an executive's retirement compensation.

REVERSE DISCRIMINATION

Most employers ordinarily strive to provide at least 60% of the final three-year average of salary and incentive compensation to employees in retirement benefits. But highly compensated employees are faced with reverse discrimination due to qualified plan limitations that restrict the amount of compensation that can be considered when calculating qualified retirement benefits to \$200,000 of income. Anything in excess of this amount is not considered. Let's look at an example:

EXAMPLE

John Keane's total final three-year average of salary and incentive compensation is \$300,000. His employer provides retirement benefits equal to 60% of final average compensation. Because of qualified plan limitations, John will only receive \$120,000 (60% of \$200,000) or 40% of his final pay in retirement, instead of the \$180,000 (60% of \$300,000) he anticipated receiving. This is a shortfall of \$60,000.



A SOLUTION: SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN (SERP)

One way a business can offset reverse discrimination is to implement a SERP for its key employees. The corporation has the flexibility of selecting the employees that it wants to include in the plan. A SERP increases retention by rewarding key employees with a "total compensation" package. It is a simple and powerful way to provide key employees with supplemental retirement income.

HOW DOES A SERP WORK?

The employer and the key executive enter into an agreement. This agreement states that the employer will pay the executive a certain amount of money, either over a period of time or in a lump sum, upon death, retirement or termination of the plan. The executive does not make contributions to the plan. When the SERP benefit is paid, the executive receives taxable ordinary income and the employer receives a tax deduction.

INFORMALLY FUNDING WITH LIFE INSURANCE

A SERP may be informally funded with a life insurance policy. The employer is both the beneficiary and the owner of the policy. Financing a SERP with life insurance provides benefits to the employer and employee. The policy's cash value grows income tax-deferred.¹ Withdrawals up to the employer's cost basis can usually be taken from the policy without income tax consequences. Once withdrawals have been taken up to cost basis, loans can be taken from the policy without triggering income tax.² The death benefit typically passes income tax-free and can be used by the employer to recover costs of the plan.

ERISA CONSEQUENCES OF A SERP

As with all types of non-qualified deferred compensation plans, the application of ERISA should be considered. However, in many instances, the SERP will be exempt from many ERISA requirements as a "Top Hat" plan. A plan may qualify as a Top Hat plan if it is created for the purpose of providing benefits to a select group of top management or highly compensated employees.³ A Top Hat plan must be in writing and notification must be filed with the Department of Labor within 120 days of the adoption of the plan.

SUMMARY

A SERP can be an excellent way to retain, reward, and recruit key employees. It has minimal set-up costs and is easy to implement and maintain.

1 The cash value of a life insurance contract grows on an income tax-deferred basis. Unlike most other investments, the employer will not pay income taxes on the life insurance held by the employer to informally fund the SERP benefits. This aspect of life insurance makes it an excellent alternative to stocks and mutual funds as a funding mechanism.

2 Withdrawals and loans from life insurance policies which are classified as modified endowment contracts may be subject to tax at the time the withdrawal or loan is made. A federal tax penalty of 10% may also apply if the withdrawal or loan is made prior to age 59½. Withdrawals and loans have the effect of reducing the death benefit and cash surrender value. Lapse of a life insurance policy may cause adverse tax consequences.

3 A detailed discussion of ERISA and the Top Hat exception is out of the scope of this piece. Before implementing any non-qualified plan, the possible application of ERISA should be considered.

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