Penn Mutual | ADVANCED SALES

Supplemental Employee Retirement Plan (SERP)

What is a SERP?

A supplemental employee retirement plan, SERP for short, is a form of non-qualified deferred compensation funded solely by the employer. A SERP can be designed as a Defined Benefit (X% of salary over a specified time frame) or Defined Contribution [specified annual contribution dollar or formula based].

Why use a SERP?

Retirement income is the focus of most employees. With limitations on Social Security and employer sponsored defined benefit plans highly compensated employees need assistance in reaching their retirement goals. Using a SERP to reward “Top-Hat” (highest compensated) employees avoids having to share an equity position, and a SERP has the advantage of deferring income to the future avoiding potentially higher income tax rates during an employee’s highest earning years. Also, the company can use a life insurance policy to defer income tax on investment gains during the accumulation period and beyond. The insurance policy can become a self-completing option in the event of pre-mature death of the employee providing heirs a death benefit.

Who is best suited for a SERP?

Employers wanting to assist their highly compensated employees and unconcerned with a current tax deduction must be careful to restrict participation in their SERP so that they remain primarily for the purpose of providing deferred compensation for a select group of “Top-Hat” employees. Maintaining this restriction is necessary in order for the SERP to continue to be exempt from coverage under the qualified plan rules of the Employee Retirement Income Security Act of 1974 (ERISA) governing participation, vesting, funding, and fiduciary requirements. Presently there is no formal bright-line definition of a Top-Hat group.

However, over the years, without citing the specific case law, some court benchmarks have included these definitions for “Top-Hat” employees:

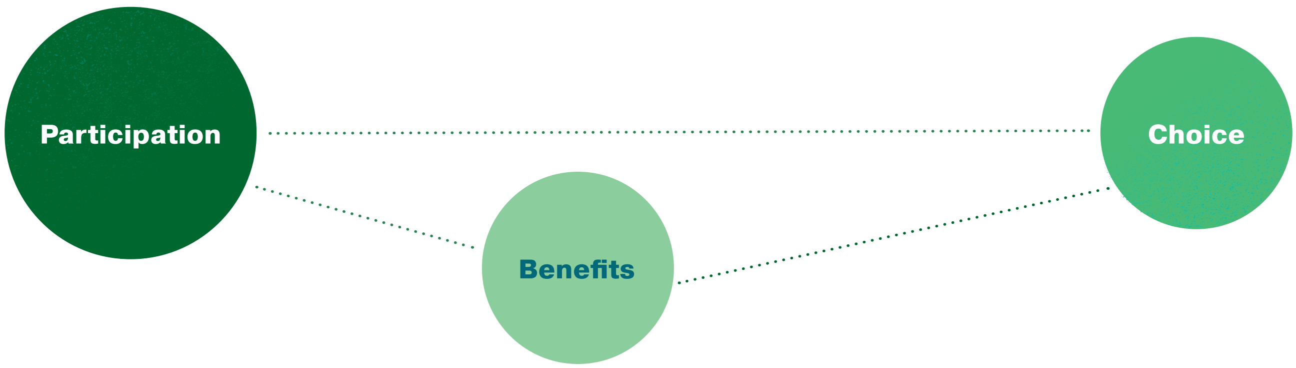
Those individuals with significant managerial duties

A group representing 5 percent or less of the employee population
(though there have been some court cases where higher percentages have been deemed to meet the exemption)

The average compensation of the covered group is three times the average of the non-covered group

What are the features of a SERP?

The employer initiates a plan hoping to retain key employees. In a SERP plan the employer chooses who may participate and the benefits can vary by employee. There are no plan contribution limits and benefits can be restricted at the employer's discretion.



What are the challenges of a SERP?

The first and major drawback is that the employer isn't entitled to a tax deduction during the accumulation phase of the plan and must wait until the distribution phase of the plan for the deduction. Therefore, the income tax rate of the employer is a substantial consideration. An employer should consider the impact of income taxes before participating. Additionally, the accumulated funds or investments must remain available to the general creditors of the employer. Furthermore, the investment performance risk is born by the employer. Corporations should also be aware of potential alternate minimum tax ("AMT"). If a corporate employer is the owner of a life insurance policy, the annual inside buildup (cash value) and death proceeds are among the factors that may subject the employer to the AMT.

How is a SERP funded?

A SERP is informally funded – meaning assets of the employer are set aside but must remain subject to the general creditors of the employer. The employer may choose any investment vehicle but consideration should be given to the amount of risk and impact of income tax on the investment vehicle. Furthermore, consideration may be given to cost recovery too. When weighing all these factors, life insurance has identifiable advantages.

How does a SERP work?

Board of Directors adopts the plan and the employer enters into a formal agreement with the executive.

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Employer informally funds the future liability.

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Executive receives benefits at separation of service, death, disability, hardship, specified time, or change of control.

Life insurance can be used as an informal funding vehicle. The company is the owner, beneficiary, and premium payer. The executive is the insured. The premiums are NOT deductible. There is an option to endorse some of the death benefits to the heirs of the executive in exchange for paying reportable economic benefit costs.

What are some of the legal requirements to establishing a SERP?

A qualified attorney should assist in drafting a resolution [if needed], an adoption agreement, establishing compliance with sections 101(j) and 409A and filing the annual income tax compliance forms [e.g. 8925] if necessary.

Important Information for Illustration

Employer's Vital Information

Name: State of domicile:

Tax structure (Note: an LLC is NOT a tax structure):

Combined federal and state income tax rates:

Does the employer want a current tax deduction? [If yes, perhaps a SERP is NOT the best solution]:

Will the employer and the employee contribute or just the employer?

What are the contributions and how are they determined?

Will the contribution increase over time?

How long will contributions be made?

Employee's Vital Information

Name: Gender:

Date of birth: Underwriting classification:

Is the employee an owner of the employer? If yes, what %?

Is the employee related to an owner of the employer? If yes, relationship?

Combined federal and state income tax rates:

What is the premium amount and mode of payment?

How long will premiums be paid?

Do you want to specify a death benefit?

Is the death benefit, level or increasing and any changes?

What is the solve goal?

What is the rate of return, if applicable?

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