THE NAUTILUS GROUP®

GUIDEPOST

Supplemental Executive Retirement Plan

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A supplemental executive retirement plan (SERP) is a nonqualified deferred compensation plan between an employer and a key employee that provides supplemental retirement income to the employee. With an employer funded SERP, the employer makes contributions to the plan and, with some plans, the employee may also be able to contribute to the plan. At the distribution date as specified in the agreement, the employee will receive the benefit promised under the plan.

An employer may consider implementing a SERP if the employer wishes to:

- Attract, retain, and reward key employees who are important to the company's success;
- Provide an incentive for key employees to remain with the company;
- Create "golden handcuffs" for key employees, making it costly for them to leave or become a competitor of the company; or
- Provide employees with supplemental retirement benefits in addition to other retirement plans currently in place.

Supplemental Executive Retirement Plan Design

Defined Benefit SERP

A defined benefit SERP mirrors a traditional pension plan where the employer provides a specified benefit to the employee based on a specific formula, such as percentage of the employee's income. Defined benefit SERPs are generally funded only with employer contributions. The plan design can be customized to the specific needs of the employer and employee; however, distributions are usually designed to align with the employee's retirement.

Defined Contribution SERP

A defined contribution SERP is designed to operate like a 401(k) plan where the employer makes predetermined contributions to the plan and the benefit the employee receives will vary depending on the accumulated value of the employee's account at the designated distribution date. The amount of contributions could be based on company profits or the employee's achievement of certain performance goals. Defined contribution SERPs are usually funded only with employer contributions, but with some plans the employee may also be able to contribute to his/her account. As with a defined benefit SERP, a defined contribution SERP can be customized to the specific needs of the employer and employee; however, distributions are usually designed to align with the employee's retirement.

Implementing a SERP

To implement a SERP, the employer and the key employee enter into a written SERP agreement, drafted to comply with Internal Revenue Code (IRC) §409A (Section 409A). The agreement defines the duties and obligations of the employer and the employee, including benefit amounts and when benefits will be paid. Usually the agreement provides that the employee must remain with the company for a certain term of years or until his/her retirement; however, the agreement may allow the employee to vest in certain percentages of the benefit at stated time intervals. At the distribution date as stated in the plan (such as the employee's retirement), the plan would pay income to the key employee for a period of years, as defined in the agreement. The plan can be structured such that the employee will forfeit all or part of the benefit if he/she leaves employment prior to the date specified in the agreement. The plan can also provide a survivor benefit to the employee's family in the event the employee dies prior to the time benefits under the plan are paid in full.

Supplemental Executive Retirement Plan Funding

A SERP must be unfunded for IRC and Employee Retirement Income Security Act (ERISA) purposes to avoid current income taxation. An agreement is generally considered unfunded if the employer's obligation is an unsecured promise to pay. This generally requires that the assets backing the agreement be subject to the claims of general creditors of the employer. The employee is a general creditor of the employer with respect to claims under the agreement.

Methods of Informal Funding

Various investment vehicles can be used to informally fund a SERP including savings accounts, bonds, stocks, mutual funds, and annuities. However, such assets would be subject to current income taxation and may be subject to market value fluctuation. Also, such assets generally provide no cost recovery, no survivor benefit, and no guarantees.

Accordingly, permanent insurance on the life of the key employee is often utilized to informally fund a SERP. The employer is owner and beneficiary of the life insurance policy and may access the policy's cash values to fund the promised benefits to the employee. The cash value of the life insurance policy accumulates on an income tax-deferred basis. Depending on the product, the cash values may be credited based on a guaranteed crediting rate. The death benefit may provide both cost recovery to the employer as well as the funds needed to provide the promised survivor benefits.

If the employer purchases insurance on the life of an employee, the employer must comply with the "Notice and Consent" requirements under IRC §101(j) to preserve the income tax-free nature of the life insurance policy's death benefit.

Supplemental Executive Retirement Plan Taxation

Income Tax Considerations - Employer

The employer receives an income tax deduction when the benefit is paid to the key employee as long as the benefit, when taken together with all other compensation paid to the key employee, is considered reasonable compensation in light of the services provided.

Income Tax Considerations - Employee

As long as employer deferrals are subject to a substantial risk of forfeiture (e.g., subject to the claims of the employer's general creditors) and if the employee is not in "constructive receipt" of deferred amounts and does not possess an economic benefit, there should be no income tax consequence to the employee upon deferral. To avoid constructive receipt on amounts deferred, the employee deferral agreement must be entered into before the compensation is earned or services are performed. Where life insurance will be used to informally fund a deferred compensation agreement, to ensure the employee has no economic benefit, he/she should have no beneficial interest in the policy, including the right to name the beneficiary for any part of the death benefit proceeds. The employer should be sole applicant, owner, beneficiary and premium payer of any policy used.

If properly structured, an employee will not include any deferred compensation in taxable income until it is received. Once received, the entire amount received will be included in taxable income for that year. Similarly, any amount received by the employee's beneficiary after death will be treated as income in respect of a decedent and will be taxable to the beneficiary in the year received. The beneficiary will be entitled to an income tax deduction for any estate tax paid resulting from the benefits being included in the decedent's estate.

FICA and FUTA Implications

The Social Security Act Amendments of 1983 established a definition of wages for the Federal Income Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA). Nonqualified deferred compensation benefits are part of an employee's FICA and FUTA wage bases at the later of the tax year in which the services are performed or the year in which there is no substantial risk of forfeiture of the rights to that amount (or, said another way, when the employee becomes vested in a benefit). In a defined contribution SERP, the FICA/FUTA tax will apply to the account balance as the account vests. In a defined benefit SERP, upon vesting the key employee pays FICA/FUTA on the present value of the vested benefit.

Estate Tax Considerations

Should an employee die prior to receiving all benefits, the present value of any obligation payable to his/her estate or beneficiaries will be included in the employee's taxable estate. Of course, if the benefit is paid to a surviving spouse, the benefit may qualify for the unlimited marital deduction.

Nonqualified Deferred Compensation Compliance Requirements

IRC Section 409A

Internal Revenue Code Section 409A, which governs the timing of when compensation and benefits can be deferred and distributed, was enacted in October 2004 and became generally effective on January 1, 2005. Section 409A applies to compensation earned in one year but that is not paid until a future year. Section 409A generally applies to most nonqualified deferred compensation plans except for IRC §457(b) plans, which are exempt from §409A.

Section 409A imposes a series of requirements on nonqualified deferred compensation plan documents, the timing of elections to defer compensation, and the timing and form of payment under a plan. Section 409A requires the plan remain in compliance from the time the plan is established until the final distribution under the plan. The following highlight some key requirements that must be met to comply with Section 409A:

- The nonqualified deferred compensation plan must be in writing and include provisions designed to comply with Section 409A.
- An employee's election to defer compensation generally must be made before the start of the taxable year in which the compensation is earned.
- The election to defer compensation must specify the amount of compensation to be deferred.
- The election to defer compensation must state the time and form in which any deferred compensation will be paid.
- Neither the employer nor the employee may retain discretion regarding when payments will be made.
- The timing of the payments generally may not be accelerated by either or both parties.
- Deferred compensation may be paid only upon one or more of the following events:
  - At a specified time or pursuant to a fixed schedule;
  - The employee's separation from service;
  - The employee's death or disability;
  - A "change in control" of the employer; or
  - The employee's unforeseen financial hardship.
- Once established under the agreement, the timing of payments generally cannot be altered unless (1) an election is made at least 12 months prior to the date of distribution provided in the agreement, and (2) the election defers the distribution by at least five years beyond the originally scheduled payment date.

If deferred compensation arrangements comply with the requirements of Section 409A, then the employee's deferred compensation is not taxed until actual receipt of compensation payments (as described above). If the arrangement does not meet the requirements of Section 409A, the deferred compensation is subject to retroactive constructive receipt (i.e., back to the time of the deferral). In addition to normal income tax, a 20% penalty tax will be imposed on the employee as well as interest at a rate 1% higher than the effective underpayment rate.

ERISA Compliance

ERISA was enacted on September 2, 1974, and was designed to protect the interest of employees in both pension and welfare benefit plans sponsored by their employers. The term employee pension benefit plan is defined in part to mean any plan, fund, or program which is established or maintained by an employer which "results in a deferral of income by employees for periods extending to the termination of covered employment or beyond." Thus, ERISA clearly covers nonqualified deferred compensation agreements that provide for distribution of the deferred amount at termination of employment.

Generally, this means that a nonqualified deferred compensation agreement must comply with certain ERISA requirements, including: (1) reporting and disclosure, (2) participation and vesting, (3) funding, (4) fiduciary responsibility, and (5) plan termination insurance. However, if a nonqualified deferred compensation plan is structured as an excess benefit plan or if it is unfunded and established only for a select group of management or highly compensated employees (often referred to as a "top hat" plan), it will be exempt from most of the ERISA requirements; the company generally must notify the Department of Labor of the plan and provide a copy of the plan document to the Department of Labor.