

M INTELLIGENCE

SUPPLEMENTAL EXECUTIVE RETIREMENT PLANS

A supplemental executive retirement plan (SERP) is a form of nonqualified deferred compensation for a selected group of executives. In a SERP, the employer and the executive enter into an agreement where the employer promises to pay future retirement benefits to the employee. In doing so, a deferred compensation liability is created, which the employer will account for annually.

FUNDING THE SERP LIABILITY

A SERP generally involves only the employer's unsecured promise to pay benefits. However, for the executive, security is often provided through informal financing arrangements such as corporate-owned life insurance (COLI). To segregate the funds earmarked for deferred compensation purposes from the employer's general funds, many plans also utilize a specialized device known as a rabbi trust.

RABBI TRUSTS

A rabbi trust is an irrevocable trust in which an employer deposits deferred compensation payable to the employee, but where the trust's assets are not protected against creditors.

This is the significant drawback of rabbi trusts: if a company becomes insolvent or goes bankrupt, both the beneficiaries and the company's creditors have access to the trust's assets.

CORPORATE OWNED LIFE INSURANCE (COLI)

Corporate-owned cash value life insurance is a common

financial vehicle used to fund the SERP liability because of the benefits it offers the employer.

With this form of life insurance, policy cash values:

- Accumulate tax-deferred
- Can be considered a corporate asset
- May be accessed to meet the SERP liability by way of tax-free policy loans and withdrawals
- Are available to the employer for use at all times

The death benefit of the insurance can be used to:

- Reimburse the employer for premiums paid
- Provide money to fund retirement benefits for other executives
- Provide a survivorship benefit to an employee's heirs, should the employee die prior to receiving all of their deferred compensation

As the name implies, COLI is purchased by the employer and insures the lives of its employees. Each employee must consent to the purchase of the insurance policy.

SOME ADVANTAGES OF ESTABLISHING A SERP

- A SERP can save the expense and administrative burden of maintaining a qualified plan such as a 401(k) or supplement a plan already in place through additional benefits to key employees.
- Without violating any anti-discrimination requirements, the employer is free to choose which employees

will be participants, as long as the plan is limited to management and highly compensated employees.

- Almost any vesting schedule can be used.
- A SERP can be a powerful employee retention device. The plan can be constructed so employees will forfeit benefits if they perform actions such as misconduct, resignation to work for a competitor, or termination of employment before retirement.

CONSIDERATIONS

- SERPs, employers, and employees must comply with Internal Revenue Code Section 409A, enacted in 2004, which regulates several aspects of deferred compensation
- SERPs are not appropriate for all employers:
 - The employer must be in existence long enough to make the payments promised under the plan, as the full tax benefits of the plan cannot be provided unless the employer exists at the time of payment, so it can take its tax deduction
 - Because of their pass-through tax structure, S corporations and partnerships may find SERPs useful for key employees who are not significant shareholders
 - Additional restrictions exist when non-qualified plans are used in tax-exempt or governmental organizations

OVERVIEW OF NON-QUALIFIED DEFERRED COMPENSATION PLANS

A deferred compensation plan that is non-qualified falls largely outside the provisions and purview of the Employee Retirement Income Security Act (ERISA). Non-qualified plans do not receive some of the tax benefits associated with ERISA-conforming qualified plans.

The primary difference between a qualified plan and a non-qualified plan is that non-qualified plans do not

generate an income tax deduction for the employer during the employee's working years. Instead, the employer must wait until the year in which deferred compensation is actually distributed to its employee to take its deduction.

However, a non-qualified plan can provide tax deferral for the employee, as well as meet employer and employee compensation objectives.

COMPARISON TO A QUALIFIED PLAN

Non-qualified plans are similar to well-known qualified retirement plans, such as 401(k)s and 403(b)s, with a few key differences.

Unlike qualified plans, a non-qualified plan such as a SERP:

- May be offered solely to a select group of managers or highly compensated individuals¹
- Allows the employer to tailor benefit amounts, terms, and conditions for different employees
- Is not subject to an annual limit on the amount of benefits it can provide (though it may only deduct amounts that are "reasonable compensation" for a given employee)²
- Involves reduced IRS, ERISA, and other governmental regulatory requirements, including reporting and disclosure, fiduciary responsibilities, and funding requirements

¹ Under ERISA, if a non-qualified plan is unfunded and maintained by an employer for the purpose of providing deferred compensation for a "select group of management or highly compensated employees," the plan is exempt from all provisions of ERISA, except for the reporting and disclosure requirements, and ERISA's administrative and enforcement provisions. The reporting and disclosure requirements can be satisfied by providing plan documents, upon request, to the Department of Labor, and by filing a simple one-time statement about the arrangement with the Department of Labor

² IRC Sections 162 and 83

Carlson Hammond
415.256.8960 (CA) – 808.532.2826 (HI) | carlsonhammond.net

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M Financial Group | 1125 NW Couch Street, Suite 900 | Portland, OR 97209 | 503.238.1813 | mfin.com