John Hancock INSURANCE

Supplemental Executive Retirement Plans

ADVISOR COMPANION

BUSINESS PLANNING

An employer-funded retirement benefit to reward and retain highly compensated key executives.

A supplemental executive retirement plan (SERP) is an employer-sponsored non-qualified deferred compensation plan. It allows employers to provide highly compensated key employees with additional retirement benefits beyond those provided by qualified plans (401(k), IRA, etc.). A SERP is financed solely through employer contributions – the employee does not contribute to the plan.

Through a SERP, employers can help highly compensated executives alleviate their worries of having a potential retirement income shortfall by providing additional retirement income. Employers benefit from a SERP because it provides incentive to the executive to continue working for the business long term (i.e., a "golden handcuff").

A SERP is typically offered in addition to a qualified plan to recruit, retain, and reward talented employees. Consider how some of the key features of a SERP plan stack up against qualified plans:

KEY FEATURES

	QUALIFIED PLAN	SERP
Freedom to choose key employees for participation	**No** – all employees must be included in plan	**Yes** – can handpick select key employees to participate
Plan acts as a "golden handcuff"	**No** – employee retains full account value upon termination from company	**Yes** – a vesting schedule may also be added added to strengthen the incentive
Subject to income limitations	**Yes**	**No**
Subject to contribution limitations	**Yes**	**No** – employer may provide as large of a benefit as they would like, plan is noncontributory for the employee[1]
Immediate income taxation to employee	**No** – qualified plan funds are typically tax-deferred	**No** – if properly structured, employee will not have to pay taxes on the benefit until actually received

Putting a Plan into Action

1. **Identify the Key Employees**

   The employer chooses which key employee(s) to participate in the plan. Because a SERP is not subject to the discrimination rules associated with qualified plans, **the employer is free to reward select employees in varying amounts and participation levels.**

2. **Execute the Agreement**

   The employer and employee enter into an agreement, whereby: (A) the employer promises to pay the employee income in the future (e.g., at retirement); and (B) the employee agrees to continue working for the employer. The amount of future income may be contingent upon a variety of factors, such as: the length of service, the employer's profitability, and other employee compensation or benefits the employee receives.

   The contract also specifies how the future SERP benefit will be determined, generally using one of two methods:

   Defined Contribution

   - Employer will credit a specific dollar amount annually to the employee's SERP account (plus interest)
     - Example: Employer contributes $10k per year until retirement and will credit the account 4% interest annually

   Defined Benefit

   - Employer will pay the employee income based on:
     - Flat dollar amount (e.g., $50k per year for 10 years starting at retirement)
     - Percentage of salary (50% of final salary for 10 years starting at retirement)
     - Formula (e.g., benefit equals 50% of the average of the employee's final three years of salary)

3. **Consider Including a Survivor Benefit**

   SERP plans often provide for the payment of the accrued benefit amount to the employee's family in the event of the employee's pre-retirement death or disability.

4. **Creating a "Golden Handcuff"**

   The employer may choose to place a vesting schedule on the plan, which can act as a "golden handcuff" to encourage the employee to stay with the company for a specified time. If a vesting schedule is in place, the employee typically will be required to stay with the employer for a minimum duration of the vesting period to receive benefits under the plan. If the employee terminates employment before the vesting schedule is complete, he/she may receive either a reduced benefit or no benefit depending on the terms of the vesting schedule.

5. **Pay Benefits at Retirement and/or Death**

   Upon the occurrence of a triggering event such as the employee's death, retirement, disability, or plan termination, the SERP benefit will be paid to the employee. The benefit will be paid out either in a lump sum or in a series of installments, depending on the terms of the arrangement.

6. **Income Tax**

   The employee will pay ordinary income taxes on the benefit income in the years in which it is received, and the employer subsequently takes a corresponding income tax deduction for the benefits paid at that time.

Funding the Plan

Although a SERP plan may be informally funded several ways, many employers choose to purchase a permanent life insurance policy on the life of the key employee to help the company pay for future benefit payments and to recover costs of the plan. When informally funded with life insurance:

- The policy is an asset of the business, which is the policy owner, premium payor, and the beneficiary.
- The employee pays no costs associated with the policy, but must consent to the insurance policy on his/her life.

Life insurance has multiple tax advantages that make it useful to the employer to informally fund a SERP plan, such as: 1. the policy cash value grows tax-deferred, 2. the policy cash value can be accessed income tax free, and 3. the death benefit is received income tax free.

Additional uses for the life insurance include:

- **KEY PERSON COVERAGE:** The life insurance death benefit also may be used as coverage for the business to replace the key employee during working years.
- **BUY-SELL PLANNING:** Depending on the corporate structure, the death benefit and/or cash value also may be used to buy out the key employee's ownership interest in the business at his/her termination from the company to fulfill the terms of an entity-redemption buy-sell plan.
- **PRE-RETIREMENT DEATH BENEFIT:** During working years the employer can provide the employee with an income-tax free survivor benefit via the death benefit. One of the ways to provide this is through an endorsement split dollar arrangement in which the business will endorse all/or part of the death benefit and the employee will pay tax on the economic benefit cost (i.e., the "rental charge"). To maximize this benefit to the employee, the employer may consider making a bonus of the rental charge (a "double bonus"), so that the employee has no out of pocket expenses.

OTHER FUNDING OPTIONS INCLUDE:

Self-Fund

The employer pays the benefits from the current cash flow of the business at the time the benefits are payable. Self-funding a SERP can place stress on current revenues if a number of participating employees retire at the same time. There is a risk that cash flow will not be available to provide the SERP benefits, creating a lack of confidence among plan participants.

Sinking Fund – Marketable Securities/Mutual Funds

The employer sets up a reserve or sinking fund where cash is invested. The employer assumes the market risk and often must invest in high-risk assets to meet its future obligations.

Another downside is that the employer must pay tax on the income earned each year.

Annuities

Similar to a sinking fund, the SERP benefits owed to a key employee are taken from the annuity. Under the tax code, however, business entities cannot achieve income tax deferral with deferred annuities.

Life insurance is most often used to informally fund a SERP due to the tax advantages and cost recovery.

Key Benefits

FOR EMPLOYERS

- **Flexibility:** Employer can select which employees will participate in the plan and determine the benefit for each employee.
- **Golden handcuffs:** Employer can impose a vesting schedule, creating "golden handcuffs" and giving the executive an incentive to stay with the company.
- **Cost recovery:** When informally funded with life insurance, the death benefit is generally received income-tax free and can provide plan cost recovery.
- **Tax deduction:** Employer receives a tax deduction at the time the retirement benefit is paid.

FOR EXECUTIVES

- **Supplemental, employer-funded retirement income:** A SERP can be used to supplement qualified plan savings with additional retirement income for highly compensated employees.
- **Pre-retirement death benefit:** Executive may also receive a pre-retirement death benefit for his/her family.
- **Protection:** The additional annual retirement income and/or survivor benefit will help to ensure that the employee's loved ones are protected.
- **Tax-deferral:** If properly structured, the employee will not have to pay income taxes on this benefit until received.[2]

HYPOTHETICAL EXAMPLE

Rosa Redman (age 45, Preferred Non-Smoker) is a Director at Erie Enterprises. Rosa is one of the most valued executives and Erie Enterprises wants to ensure that she remains with the company on a long-term basis. The company offers Rosa a SERP plan in which it will annually contribute $20,000 and credit 5% to the account. The projected benefit to Rosa at age 65 is $63,713 annually for 15 years.

1

Erie Enterprises and Rosa enter into a contractual agreement whereby the company promises to annually contribute $20,000 and credit 5% to a SERP account. Rosa's projected annual retirement benefit is $63,713 for 15 years.

2

To informally fund the SERP, and with Rosa's consent, Erie Enterprises will purchase and own a John Hancock Accumulation VUL insurance policy on Rosa's life with an initial death benefit of $626,371. The projected annual premium is $20,965 for 20 years ($419,300 total) assuming an interest crediting rate of 6.00% (5.33% net).

3

At Rosa's retirement, she will begin to receive taxable SERP benefit payments of $63,713 from Erie Enterprises. The company will receive a tax deduction of $13,380 (21% tax bracket) for each year that it makes the benefit payment to Rosa. The company will use withdrawals and loans from the life insurance policy offset the after-tax cost of the benefit ($50,333) it pays to Rosa each year.

4

Upon Rosa's death, Erie Enterprises will receive the life insurance policy death benefit income tax free. It is projected that Erie Enterprises will recover 100% of the premium cost ($419,300) through Rosa's age 90.

This chart summarizes the SERP plan to Erie Enterprises.

Year	Premium	Retirement Benefit	Corporate Tax Savings	After-Tax Cost of Retirement Benefit	Loans/ With-drawals from Policy	Net Policy Cash Surrender Value	Net Death Benefit
1	$20,965	$0	$0	$0	$0	$3,826	$644,716
10	$20,965	$0	$0	$0	$0	$232,967	$859,338
20	$20,965	$0	$0	$0	$0	$650,059	$1,276,430
21	$0	$63,713	$13,380	$50,333	$50,333	$630,745	$1,226,097
25	$0	$63,713	$13,380	$50,333	$50,333	$541,218	$1,024,764
30	$0	$63,713	$13,380	$50,333	$50,333	$395,218	$771,622
35	$0	$63,713	$13,380	$50,333	$50,333	$196,106	$497,957
40	$0	$0	$0	$0	$0	$211,602	$460,574

The life insurance data shown is taken from an illustration. It assumes a hypothetical rate of return and/or current interest crediting rate and may not be used to project or predict investment results. Unless indicated otherwise, these values are not guaranteed. We urge you to show your clients a basic illustration showing the impact of 0% and maximum sales charges and/or the guaranteed interest crediting rate and an impact it will have on policy cash value and death benefit.

Important Considerations

- **Income Taxation:** The benefits received under a SERP plan will be taxed to the employee as ordinary income when received. At that time, the employer will receive an income tax deduction for the benefit paid to the employee. If the plan is informally funded with life insurance, the premiums paid on the policy by the employer are not deductible.
- **Insurance Ownership and §101(j):** The employer will be the owner of the life insurance policy on the employee's life. The employee will have no direct access to the policy cash value or death benefit - unless a separate pre-retirement death benefit plan (i.e., split dollar) is implemented. The policy is merely the employer's choice of funding vehicle and the employer owns all policy rights. The employer must comply with the §101(j) rules (see side box) to ensure that the policy's death benefit will be received income-tax free.[3]

§101(j) COMPLIANCE

When life insurance is owned by an employer on the life of an employee, the tax code requires that certain conditions and Notice and Consent requirements be met to keep the death benefit proceeds income tax-free.
For more information please refer to **BYA: Understanding Employer-Owned Life Insurance (EOLI) and 101(j).**[3]

- **Creditors:** Because a SERP is a non-qualified plan, the employer cannot segregate assets protected from the company's creditors without subjecting the plan to ERISA. If the employer were to become bankrupt and unable to pay the SERP benefit, the employee would be considered a general creditor of the employer and would not receive preferential treatment in recovering the benefit.
- **ERISA:** The possible application of ERISA should be considered for all non-qualified executive benefit plans, including a SERP. In most instances, a SERP plan may be exempt from most ERISA requirements as a "top hat" plan.[4] **If ERISA applies, advisors should note that they may be considered a fiduciary and should take appropriate steps to comply with ERISA requirements, including conflict of interest rules.**

- **§409A:** Section 409A of the Internal Revenue Code applies to all non-qualified executive benefit plans that provide for the deferral of compensation, such as a SERP plan. The SERP plan document must comply with the rules detailed in Section 409A. Failure to comply with Section 409A may subject a participant(s) income to immediate income taxation, as well as interest and a 20% excise tax on the taxable income. For more information please refer to our **Because You Asked on 409A**.
- **Accounting Method:** If an employer commits to paying a post-retirement benefit via a SERP, then the employer must reflect the future benefit as a liability for accounting purposes. Acceptable accounting methods ensure that the present value of the future benefit is fully accrued by the time of retirement.[5] If the SERP benefit will be informally funded with life insurance, the employer will need to account for that as well. Employers should discuss these accounting considerations with their tax advisors.

Employers should consult tax/legal counsel to address these important considerations.

Conclusion

A SERP plan can be a great way for an employer to reward a key employee's hard work and loyalty to the company, especially in cases where qualified plan income and contribution limits can hinder the executive's ability to fully save for retirement. A SERP plan provides maximum control to the employer because nothing is paid to the employee unless he/she meets the years of service requirements as set forth in the plan. For an employer looking to provide extra incentive to key employees, a SERP plan can be the perfect addition to an employee's total compensation package.

Contact the John Hancock Advanced Markets team at 888-266-7498, option 3, for a customized client proposal using the JH Solutions software.

1. The amount the employer may contribute is subject to "reasonable compensation"
2. Section 409A of the Internal Revenue Code imposes extensive substantive requirements on arrangements that purport to accomplish a deferral of income or the taxation of income. By its own provisions, failure to satisfy these requirements will result in the loss of deferral of recognition and taxation of the income.
3. Section §101(j) of the Internal Revenue Code imposes income tax on the death benefit of life insurance contracts owned by the employer of the insured unless certain exceptions apply. In addition, the employer must show satisfaction of notice and consent requirements set forth in §101(j). Please see our BYA on §101(j) for more information.
4. A plan may qualify as a "top hat" plan if it is created for the purpose of providing deferred compensation for select management or highly compensated employees. A top hat plan must be in writing and a written plan document must be filed with the Department of Labor within 120 days. Qualification of a SERP as a top hat plan must be considered on a case-by-case basis.
5. FASB rules set forth in APB Opinion No. 12, as amended by FAS 109, govern the accounting treatment of a SERP. See also FAS No. 87.