

# **“SERPs Up!” ...Why Supplemental Executive Retirement Plans Are Increasing in Prevalence**

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Faced with today's global challenges, organizations need every competitive advantage to attract and retain top talent. Some organizations view supplemental executive retirement plan benefits (SERPs) as perks, while others use them as a competitive advantage in the search for executive talent. In this article we briefly comment on many of the features being used in best practice designs today. We also review the financial implications surrounding the funding of these arrangements and try to shed new light on creative design issues.

## **Prevalence of SERP Arrangements**

According to a 2005 Executive Benefits Survey\*, 69% of respondents adopted a SERP in excess of qualified plan restrictions to provide benefits to executives. The primary reason for adopting the SERP was to provide a benefit above the compensation and benefit limits imposed by IRS compensation limits under IRC 401(a)(17), (\$220,000 in 2006).

The predominant reasons for establishing a SERP are:

- To replace benefits lost by Section 401(a)(17), limit (\$220,000 in 2006).
- To replace benefits lost by Section 415 limits.
- To provide additional incentives for high-level executives to join the company.
- To provide retirement benefits that are higher than those under the qualified plan.
- To provide executives with retention incentives (“golden handcuffs” or “glue in the seat”).
- To provide targeted retirement compensation.
- To provide wealth accumulation as an alternative to stock options.

Fifty-four percent\* of respondents are informally funding their SERPs, slightly up from 52% in 2004. Ten percent of respondents are still considering informal funding within the next twelve months.

\*Clark Consulting - *Executive Benefits - a Survey of Current Trends 2005 results.*

Although these arrangements have been used primarily by larger companies, there is no reason why they should have an advantage over smaller firms in being able to establish SERPs - size alone shouldn't dictate whether an organization offers a SERP. With the expensing of stock options required by FASB, a SERP may be one of the most competitive alternatives to attract and retain key people.

Establishing a SERP can be a simple process. It may become critical in hiring your next senior executive or preventing current executives from accepting a better package elsewhere. A SERP may also help your organization compete with more powerful companies when searching for senior talent.

Our experience reveals that SERP eligibility rules vary significantly from one organization to another. The plan is *nonqualified*; therefore it is not subject to the onerous reporting, filing, and fiduciary responsibilities imposed by ERISA. This gives your company latitude in defining the eligible group. Some organizations restrict participation to a very small group while others provide a SERP to all management employees who could potentially be affected by either compensation or benefit limits imposed by government limitations on their company's qualified pension plan (IRC 415(b), \$175,000 in 2006). While the latter practice would seem to be the trend, the evidence for this is more anecdotal than statistical.

SERPs are not subject to qualified pension limitations and for this reason, the door is open to adding special features to further the organization's interest. Below are a few examples:

- *Creative Vesting*: SERPs can have literally any vesting schedule prior to retirement age or accelerated vesting that is dependent on achieving pre-determined financial objectives;
- *Back-loading benefit accrual* (e.g. 1% per year of service prior to age 55, and 3% per year of service from age 55);
- *Inclusion of bonuses* conditional upon reaching retirement age or meeting certain performance criteria;
- *Recognition of additional years* of past service conditional upon staying with the firm a certain number of years, performance or both;
- *Use defined contributions* (e.g. 10% of salary) giving the executive investment control of plan assets like a 401(k). However, in the event of a change in control, the plan converts to defined benefit (e.g. 60% of final pay);
- *Vesting or credit* given for industry or prior company service; and
- *Mid-career hires*: The plan can provide a separate tier of benefits to attract such talent.

Flexibility is critical when it comes to attracting and retaining key executives. Tailoring the SERP program, to fit a company's objectives, is important to align the interest of shareholders with those of the executive helps to achieve company objectives as well as satisfying ISS concerns. As a result, a "one size fits all" approach is a thing of the past.

### **Benefit Formula Could Have Impact on Company Cost**

The majority of organizations tie the SERP benefit formula to a total compensation (salary and bonus). Given the increase in incentive compensation, bonuses can be quite large when an organization performs well, and conversely no bonus being paid during difficult years is common. If inclusion of bonuses is not considered carefully the impact on the executive's SERP can also be quite severe since most SERPs are based on final or best average earnings. You don't want an executive exiting because he or she had a great year and sees a down turn in the future.

Consequently, some organizations have resolved to simply exclude bonuses for the SERP formula to avoid the issues arising from the volatility of bonuses. Those organizations that don't include bonus income tend to provide a larger benefit accrual rate compared to those that do (e.g. 70% of salary vs. 50% of salary and bonus).

We have also found organizations that have decided to deliver compensation in other ways. Instead of including bonuses in the SERP formula they may offer nonqualified deferred compensation (give the executive ability to save bonus income on a pre-tax basis), stock options, or deferred restricted stock units.

In keeping with current best practices, should organizations include bonuses in the SERP formula? The answer to this question will continue to vary by organization. The SERP should be viewed as another tool that can be used to attract and retain key employees. It plays a major part in the total compensation and benefits strategy of your organization. (Chart I).

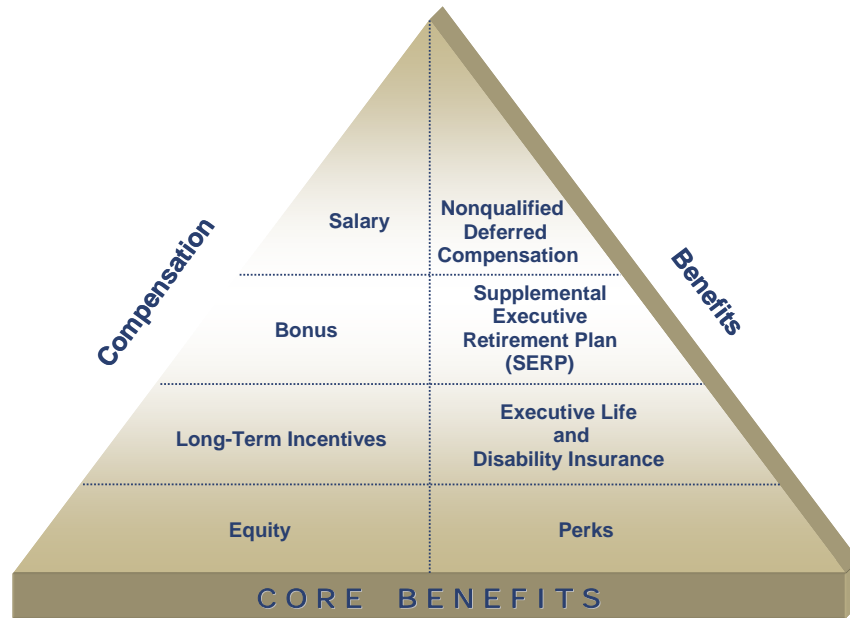


Chart I

## Non-Compete Agreement

Generally, the courts do not favor non-compete agreements because they run against the fundamental principal of free enterprise. However, if the clause is highly specific and not overly burdensome upon the executive, the courts may be amenable to enforcing the agreement.

Since the SERP is a nonqualified plan funded by the company, one of the key reasons for providing this additional benefit could be to help prevent certain activities that can be potentially harmful to the organization. Some examples:

- Solicitation of business from current or past customers,
- Engaging in business within the same product lines and or going to work for a certain list of competitors, and
- Solicitation of employees of the organization to work for a competing business enterprise.

The message is... "we will continue your SERP benefits when you retire, however...if you violate our "bad boy" provisions...you lose!"

It is reasonable to expect that non-compete clauses for SERPs will become commonplace. As the war for executive talent intensifies, the SERP can be one more way for organizations to retain key employees or, at the very least, make the employees think twice before joining competitors.

## To Fund or Not To Fund

According to survey data a significant percentage (40% of Fortune 1000) of organizations' have chosen not to pre-fund SERPs. Many believe it is too expensive to do so. Whether you are a financial officer, a human resources executive or a board member, you should consider the following.

Deciding whether to fund a SERP could be narrowed down to one question - *where will your organization be five years from now?* More specifically:

- Will it exist and operate in the same manner as it does today?
- Will it have grown significantly through mergers and acquisitions or other means?
- Will it be acquired or “swallowed” by a larger organization?
- Will it have gone bankrupt?

If you had difficulty answering these questions, consider that when executives retire at age 55 or 60, they may live another 20 to 30 years or more. For that period, executives may feel uncomfortable leaving the security of a significant portion of their retirement in the hands of their previous employer. And they have even less reason to put their faith in a new organization created through merger or acquisition. Given how executives feel about the security of their retirement, funding your SERP may be a critical attraction tool when hiring new executives.

While a case for funding a SERP from the executive's perspective has always been obvious, one still needs to be convinced it is affordable. Consider these arguments in favor of funding:

1. Accounting standards have clarified the accounting treatment of SERP promises. Under these rules, the net impact of informally funding the SERP may actually reduce the net impact on your income statement. The most prevalent funding device used today is corporate-owned life insurance. If you looked at the potential impact of COLI funding more than a couple of years ago, you should look again. Today, companies are discovering the advantages of PPCOLI (private placement corporate-owned life insurance). The development of this new generation of products is the clarion call to corporations to wake up to and take another look.
2. Historically, the cost of funding SERP arrangements has been considered prohibitive - it was often compared with the cost of funding a qualified pension. This comparison is somewhat academic since there is no vehicle comparable to a qualified pension available to fund SERPs. PPCOLI provides an opportunity to build an asset menu similar to a qualified plan within the tax-advantaged “wrapper” of life insurance. Over

the life of the plan the cost for the “wrapper” can net to less than 40 bps, compared to 40% tax on the taxable investment portfolio.

3. Under this arrangement, if the after-tax return earned on the PPCOLI assets is equal to or higher than the organization’s after-tax cost of debt, there is little or no additional cost (i.e., no negative income statement impact) associated with funding SERP arrangements. Here’s an example to illustrate the point:
  - Assume your corporate tax rate is 40%.
  - If your cost of borrowing is 6%, your after-tax cost of borrowing capital is therefore 3.6%.
  - Let’s assume we have a 50-year old executive, who is projected to receive a \$500,000 SERP benefit starting at age 65, to be paid for 15 years. If we started that benefit today, the first year accrual under FAS 87 would be \$154,666 (\$92,799 net of taxes) based on the government’s interest rate of 5.9%.
  - Let’s also assume we would like to fund this arrangement over the next 7 years and we would make contributions to the sinking fund of \$236,644 per year for the seven year period. (Chart II illustrates the P&L impact of using this arrangement.)
  - As you can see from column 4, to offset the negative impact on your net income (column 5), we have the increase in asset value of the insurance contract (column 2).
  - Therefore the P&L cost of funding your SERP arrangement is \$78,371 in year one vs. \$92,799 on an unfunded basis. On a net present value basis, the cost for all years would be close to \$0.
  - However if your expected interest on assets is 7% rather than 6%, then the impact would be nil! In other words, the after-tax return earned on the informal funding would be equal to the after-tax cost of debt.

Can your expected return on invested assets under the informal funding (7.0% in our example) be higher than your cost of borrowing (6%)? It is definitely possible - you can invest in a diversified portfolio of equity and debt instruments that have credit ratings similar to your organization.

By investing in a diversified portfolio in the PPVUL contract, you “hit two birds with one stone”.

1. You’re able to manage your equity and debt portfolio tax-deferred inside the life insurance contract, selecting best in class managers.
2. The realized gains (i.e., the rise in stock price, interest and dividends caused by portfolio turnover) will accumulate without tax, as the inside build-up of assets in the insurance contract are tax-deferred. In fact, if the insurance is held until death of the insured, the entire portfolio is tax-free under the rules of life insurance.

The PPVUL gives you an open architecture for selecting investment classes and managers. The turn cost is how well you manage the portfolio. The following chart depicts the cost differential between a SERP funded via this informal funding method with PPVUL, and an unfunded SERP for various levels of return from the PPVUL. The chart assumes a 40% corporate tax rate and pre-tax borrowing of 6%.

### SERP Funding: The "True" Cost

Plan Year	Premium	Cash Value Increase	Mortality Proceeds	Earnings Impact From Insurance	Net Earnings Impact From Benefits	Net Earnings Impact		Net Cash Flow	
						Annual	Cumulative	Annual	Cumulative
	(1)	(2)	(3)	(1)+(2)+(3) = (4)	Benefits P&L = (5)	(4)+(5) = (6)	(7)	(8)	(9)
1	(236,644)	251,072	0	14,428	(92,799)	(78,371)	(78,371)	(236,644)	(236,644)
2	(236,644)	264,800	0	28,156	(103,750)	(75,594)	(153,965)	(236,644)	(473,288)
3	(236,644)	278,700	0	42,056	(115,669)	(73,613)	(227,578)	(236,644)	(709,932)
4	(236,644)	294,428	0	57,784	(128,634)	(70,850)	(298,428)	(236,644)	(946,576)
5	(236,644)	310,351	0	73,708	(142,726)	(69,018)	(367,446)	(236,644)	(1,183,220)
6	(236,644)	327,059	0	90,415	(158,033)	(67,618)	(435,064)	(236,644)	(1,419,864)
7	(236,644)	347,883	0	111,239	(174,649)	(63,410)	(498,474)	(236,644)	(1,656,508)
8	0	120,528	0	120,528	(192,676)	(72,149)	(570,623)	0	(1,656,508)
9	0	139,057	0	139,057	(212,223)	(73,166)	(643,789)	0	(1,656,508)
10	0	147,929	0	147,929	(233,405)	(85,476)	(729,265)	0	(1,656,508)
<b>PY - 10</b>	(1,656,508)	2,481,806	0	825,298	(1,554,563)	(85,476)	(729,265)	0	(1,656,508)
<b>PY - 20</b>	(1,656,508)	4,514,334	0	2,857,826	(3,849,418)	124,860	(991,591)	(300,000)	(3,156,508)
<b>Life of Plan</b>	(1,656,508)	0	9,996,791	8,340,283	(4,500,000)	2,433,275	3,840,283	9,696,791	3,840,283
							<b>NPV@3.6%</b>	0	

Chart II

The bottom line is that the cost of securing SERPs may be lower than you think. Many additional benefits of funding these obligations, including benefit security, are in play. Several organizations put these assets in Rabbi Trusts to provide some protection against a default on benefit payments or a change in control. Besides, do you want your SERP to be contingent on the cash flows of future management or another organization that may acquire your company?

## Summary

To summarize, if the after-tax return earned on the informal funding is equal to or higher than your after-tax cost of debt, no additional cost associated with the funding of your SERP arrangements may exist.

Even after considering all of these points, an organization may still not want to fund its SERPs. It simply might not be able to borrow at a reasonable cost or it might want to use its limited borrowing power for projects that will yield higher return than the informal funding. In other words, you have to consider opportunity cost.

On the other hand, how do you measure the opportunity cost of not being able to attract, retain, and motivate key people? Obviously, the answer to this question cannot be quantified and will vary for each organization.

Now may be an appropriate time to dust off your SERP funding file. A review of the “true” cost implications of the various funding vehicles available may help your organization bring closure to this sensitive issue.

*Investors should discuss their own unique situation with their tax and financial professionals. RCG does not give legal or tax advice and the opinions presented in these materials should not be construed as such. All examples are hypothetical and not intended to represent any specific investment.*