

Helping to ensure a win

How to use SERPs to reward and retain key employees **Interviewed by Sue Ostrowski**

If your key executives left, could your business continue to function, or would the loss cripple your company?

If the thought of losing your key people — whether to another employer or because of death or disability — keeps you up at night, a Supplemental Executive Retirement Plan (SERP) may be the answer, says Mark J. Dorman, president of Dorman Farrell, LLC.

“Finding and keeping talented difference-makers in an organization is tough,” says Dorman. “But, if your 401(k) or other retirement plans aren’t meeting the retirement income needs of your key people, SERPs can help you reward and retain those individuals.”

Smart Business spoke with Dorman about how SERPs can be a big win for both key employees and the company.

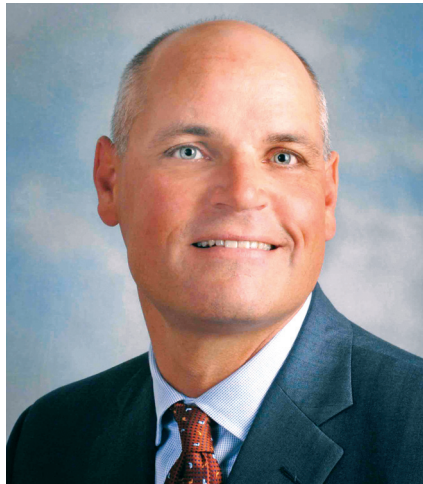
What is a SERP?

A SERP is a non-qualified plan, which means it is not subject to the same restrictive federal regulations and tax laws that govern qualified retirement plans, like 401(k), profit sharing and pension plans. SERPs work essentially like a private pension plan for each key employee for whom the employer wants to offer it. The employer makes a legally-binding agreement to pay additional compensation to the employee at some point in the future — usually retirement.

How does a SERP benefit both the employer and the key employee?

The key benefit for the employer is the ability to offer a really attractive future benefit to the employee — a benefit that makes the employee want to stay with the company. For example, if a business owner said to a key executive ‘I need you to stay with the company until age 60 to get the business where it needs to be,’ the executive may be reluctant to make that commitment. However, if the owner said ‘If you stay until age 60, I will pay you \$X in annual retirement income between the ages of 61 and 70,’ suddenly the idea of staying becomes a lot more attractive. This incentive to stay with the company is often referred to as ‘golden handcuffs.’

Now is a good time to focus on executives’ retirement benefits. While government regulations have always restricted the deferrals highly compensated employees (annual incomes greater than \$110,000 per year) can make to traditional 401(k) plans, what little they have been able to defer has likely taken a hit with the economic downturn and lackluster stock



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market performance. Executives are likely to have concerns about their retirement income and will find a SERP an appealing option.

SERPs also offer the employer a great deal of flexibility in designing the plan. Because they are not subject to the same regulations as qualified plans, the employer can pick and choose which employees are offered a SERP and design specific provisions. For example, the employer may choose to include a vesting schedule that vests the key employee over several years or, alternatively, requires the employee to stay for the entire term of the agreement to receive any benefit at all.

How do employers fund these plans?

SERPs don’t necessarily have to be funded at the time of the agreement. But if you don’t fund it, you create an unfunded liability on your books that you will have to pay out of future cash flow.

The vast majority of SERPs, particularly in private companies, are informally funded using either taxable investments, such as mutual funds, or tax-favored investments in the form of corporate-owned life insurance (COLI). The company owns, pays for, and is

the beneficiary of the life insurance policy. The growth on the cash value accumulation is tax-deferred and used to pay the SERP benefit, while the death benefit provides corporate cost recovery to the plan sponsor.

Here is an example of how a corporate-owned life insurance policy can be structured to fully fund a SERP: Assume an employer has agreed to pay a SERP participant \$50,000 a year for 10 years between the ages of 61 and 70. The employer purchases a corporate-owned life insurance policy and uses the cash value accumulation to pay that benefit during those years, and takes a tax-deduction for the benefit during each year it is paid. Once the SERP benefits are fully paid, enough cash value remains in the policy that it stays in effect throughout the employee’s lifetime (even after leaving the company). When that person dies, the company receives the life insurance benefit tax-free, recovering the cost of the years of employer-paid premiums.

Are there any other considerations?

Yes. It is important for the employer and the employee to understand that one of the key requirements for non-qualified plans, including SERPs, is that there must be a substantial risk of forfeiture to the plan participant. If this requirement is not met, the IRS will deem the benefit to be ‘funded’ and immediately taxable to the participant. The primary risk to the participant is that the funds are subject to claims of the company’s creditors. Additional planning is needed to protect the participants from a change in control and other factors that may threaten the security of their benefit payments.

What should an employer do to get started?

Companies should first enlist the help of experienced professionals. An experienced executive benefit consultant, along with the company’s accountant or attorney, can help you design a SERP agreement, determine appropriate financing and communicate with the key employee. The initial process usually takes between nine and 12 months. Once the plan is up and running, the administration is really quite simple. <<

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