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What to Think About When Designing a SERP

Market Trend: In a competitive labor market, employers may want to consider providing additional retirement benefits to key employees under a supplemental executive retirement plan, otherwise known as a “SERP.”

Synopsis: SERPs are a type of nonqualified deferred compensation plan. SERPs come in many shapes and sizes. The SERP benefit may look like a pension plan’s “defined benefit,” specifying an annual lifetime retirement benefit starting at age 65. Alternatively, the SERP might be designed as an account balance with fixed or discretionary employer contributions. In any case, the SERP must comply with various requirements under ERISA and the Internal Revenue Code. This article explores key design considerations and choices for SERPs and describes key compliance requirements that apply.

Takeways: An employer considering adopting a SERP should establish a design that corresponds to the business goals for the SERP. Additionally, the employer should understand the compliance requirements that will apply and involve the right team of experts to balance the various compliance considerations with design choices.

What is a SERP?

Broadly speaking, a SERP is a type of nonqualified deferred compensation plan under which an employer provides a retirement benefit for a select group of management or highly compensated employees. Typically, a SERP does not include an elective deferral feature, although an employer may choose to include one.[1] The retirement benefits provided under a SERP are in addition to the benefits provided under the employer’s tax-qualified retirement plan(s).

However, as outlined below, SERPs come in a variety of shapes and sizes. An employer should consider what business purposes it intends to meet by adopting a SERP and match those purposes with the design features that best meet those needs. The discussion below focuses on SERPs adopted by for-profit employers. SERPs for non-profits are subject to additional restrictions under the Internal Revenue Code of 1986, as amended (the “Code”) that are outside the scope of this article.

[1] See the March 2022 FRMP "What to Think About When Desiging Nonqualified Deferred Compensation Plans in the Resource Library.

Why provide a SERP?

Employers commonly adopt a SERP to provide key employees with a market competitive retirement benefit that cannot be provided through a tax-qualified retirement plan due to IRC limits. SERPs intended to serve this purpose are often closely coordinated with an employer's related tax-qualified plan.

A SERP may also serve as a retention tool. SERPs are technically considered "pension plans" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"); however, as a "top-hat plan," they are exempt from most of ERISA's substantive requirements, including ERISA's minimum vesting rules. As a result, SERP benefits can include a wide range of vesting conditions intended to encourage long-term employment, limited only by the imagination.

Additionally, SERP benefits may be used as a form of incentive compensation. The amount of the SERP benefit can be tied to specified business goals. For example, a defined contribution SERP (see below) can condition the amount of the annual contribution on attainment of annual business goals.

Finally, SERP benefits may provide additional long-term compensation to key employees at private companies that do not (or cannot) provide equity compensation opportunities. The SERP benefit can fill the equity compensation void in a competitive total compensation package when competing for talent with other companies that do offer equity compensation. While a SERP may not provide the high upside opportunity that equity compensation can provide, it also has less downside risk for the participant.

Defined Benefit v. Defined Contribution Alternatives

The first major decision point in designing a SERP is choosing whether the retirement benefits should be described as either:

- a defined benefit amount payable upon retirement (a "DB SERP"), or
- an employer contribution periodically credited to a notional account in the participant's name, adjusted with interest or deemed earnings, and payable upon retirement (a "DC SERP").

The benefit formula for a DB SERP can vary widely. A common approach is to target a level of desired income replacement at a future "normal retirement date," such as age 65. The design might target an annual retirement benefit starting at the normal retirement date equal to a specified percentage of base salary or "final average compensation." For a formula based on "final average compensation," the SERP should specify the components of compensation considered – *e.g.*, base salary, or salary plus annual bonuses earned – and the period over which the amount is determined – *e.g.*, the high three years out of the last ten years preceding retirement. The formula might also provide that the maximum target percentage is reached only over an extended accrual period of service. The final benefit earned may be expressed as a life annuity (including possibly a joint and survivor annuity) or annual installments for a fixed period (such as ten years).

A DC SERP benefit is based on the value of a notional account in the participant's name. The account is credited with employer contributions, and thereafter adjusted for deemed interest or earnings based on returns of deemed investments (such as the investment choices provided in the employer's tax-qualified 401(k) plan). The employer credits may be based on a fixed percentage of pay or could be variable based on company or participant performance. Payment of the vested account upon retirement may be in a lump sum and/or in installments, or could include a participant election as to the form of payment (subject to compliance with Code Section 409A ("409A") – see discussion below about tax code compliance considerations).

DB SERPs can be subject to more complex accounting issues than DC SERPs. The amount of the balance sheet liability for those benefits will depend on various assumptions, such as future interest rates and mortality tables (if benefits are provided as a life annuity). Typically, the employer will need an actuarial firm to ensure proper accounting of the DB SERP liabilities. These liability valuation issues can also make informal funding for DB SERPs more challenging than for DC SERPs (see discussion about informal funding below). Just as employers have been trending away from providing tax-qualified defined benefit pension plans, DC SERPs have become somewhat more common than DB SERPs in recent years.

Qualified Plan Offsets

SERPs intended to supplement tax-qualified retirement plan benefits may use a benefit formula that is coordinated with the tax-qualified plan's benefit formula. A common approach, sometimes referred to as a "restoration" plan, defines the SERP benefit with an "A minus B" formula, where:

- "A" is the benefit the participant would have accrued or been credited under the tax-qualified plan had Code limits on total benefits and annual compensation not applied, and

- "B" is the benefit the participant actually accrued or was credited with under the tax-qualified plan.

An "A minus B" formula may be used with either a DB SERP or DC SERP. In a DC SERP, the benefits may be based on the matching contribution formula or employer nonelective contribution formula that applies in the related tax-qualified 401(k) plan.

Alternatively, the SERP could provide that the "A" portion of the benefit is based on an enhanced formula as compared to the tax-qualified plan. For example, the relevant accrual rate or contribution rate may be at a higher percentage of compensation, or the definition of compensation used for the SERP could include elements not counted in the tax-qualified plan (such as annual incentive awards or amounts that have been deferred to a nonqualified deferred compensation plan).

Having the SERP benefit calculated using additional types of offsets, such as offsets for other nonqualified deferred compensation benefits, should be carefully reviewed. There are specific rules under 409A about when offsets in a SERP formula are permissible. Furthermore, the "contingent benefit rule" under Code Section 401(k) should be considered if the benefit in a SERP is linked to a tax-qualified 401(k) plan benefit.

Tax Code Compliance Key Issues

SERPs are intended to result in ordinary income to the participant only when amounts are actually paid. To this end, the SERP will need to be designed to comply with 409A. There is also a special timing rule that applies to FICA taxes that can result in FICA taxes being owed when SERP benefits are vested rather than when paid. The following provides a high-level summary of these two key tax compliance issues.

409A. 409A applies to any "nonqualified deferred compensation plan" as defined under 409A, including SERPs. 409A imposes a number of compliance requirements on SERPs, including the following:

- *Compliant Payment Rules*. 409A requires that the time and form of payments (*e.g.*, lump sum, installments, or annuities) be fixed at the time of initial deferral. The event triggering payment must be limited to one of six permitted payment events: (1) death, (2) "disability" (as defined under 409A), (3) "separation from service" (as defined under 409A), (4) a fixed date or fixed schedule, (5) a "change in control" (as defined under 409A), or (6) an "unforeseeable emergency" (as defined under 409A). The payment rule can include "earlier of" or "later of" combinations of these events, such as the earliest of death, disability, or separation from service.

- *No Accelerations or Further Deferrals (With Limited Exceptions)*. Once the time and form of payment is fixed under the SERP, the payment timing generally cannot be changed without violating 409A. There are, however, certain limited exceptions. For example, in certain cases a SERP can be terminated and benefits paid out in a lump sum without violating the prohibition on accelerated payments. Also, if the SERP allows for it, the time and/or form of payment can be changed so long as (i) an election for the change is made at least twelve months before the payment would have otherwise commenced and (ii) the new time/form of payment is delayed by at least five years from when the payment would have otherwise commended (sometimes called a "12/5 election").

- *6-month Rule for Public Companies*. Public companies that sponsor SERPs also must require payments to certain "specified employees" (as defined under 409A) that are triggered by a separation from service be delayed by at least six months following the separation from service. 409A was adopted in part as a response to certain perceived abuses at companies like Enron, where executives received payouts of their nonqualified deferred compensation benefits shortly before the company failed (while other employees suffered huge losses in their 401(k) plan accounts that held company stock). 409A's six-month payment delay requirement is a response to this context, and basically addresses a "rats fleeing the sinking ship" concern. The "specified employees" are an annually determined group, generally limited to the top 50 paid key employees.

- *Compliance in Form and Operation*. 409A requires that the SERP (i) be in writing and (ii) include terms that comply with 409A. If the SERP includes noncompliant terms (such as impermissible payment events or discretion as to timing of payment), then the SERP is considered to fail to comply with 409A. Although a SERP may comply with 409A in form, it also must be operated consistent with the requirements of 409A.

A SERP that fails to comply with 409A (either in form or operation) triggers significant adverse tax consequences to the participants. If a failure occurs, the entire SERP benefit must be included in the participant's income in the year of failure. Under 409A, the failure applies not only to the specific amount involved under the participant's SERP, but all amounts due to the participant under any other plans of the employer that are required to be aggregated with the SERP (referred to as the "plan aggregation rule").[2] The participant must also pay an additional 20% tax, plus potentially a "penalty interest" additional tax under 409A. The employer must report the failure on the participant's Form W-2 or Form 1099 (as applicable). If the employer fails to properly withhold income taxes for the year of failure the employer may be liable for penalties for failure to properly report and withhold the compensation paid to the participant. The IRS does, however, provide a pair of correction programs that allow employers to correct certain operational and form failures if fixed quickly (generally within two years after the year of failure).[3]

Although 409A imposes a number of restrictions on the time and form of payments, there are design opportunities that include degrees of participant flexibility to make payment elections. For DB SERPs, the plan could permit a participant at time of initial eligibility to elect a lump sum payment in lieu of installments or an annuity (although in that case the DB SERP will need to specify the relevant interest and mortality assumptions to determine the lump sum value of the benefit at the time of payment). For a DB SERP that pays benefits as an annuity, 409A permits participant elections as to the specific form of annuity at the time of commencement, as long as the permitted annuity choices all have the same actuarially equivalent value. DC SERPs may also allow participant elections at time of initial commencement, or prior to the year of a particular contribution, to elect the time and form of payment from a menu of 409A permitted alternatives. Adding participant elections involves a trade-off, as increased participant flexibility usually involves increased administrative complexity. Each employer needs to decide for itself what the right balance is between these competing considerations.

FICA Special Timing Rule. FICA imposes a tax on both employers and employees based on "wages" under Code Section 3121(a). The FICA tax includes the Social Security tax (at a rate of 6.2% for both employer and employee, subject to annual wage cap) and the Medicare tax (at a rate of 1.45% for both employer and employee on all wages without a cap, plus an additional 0.9% on the employee on wages over a specified level depending on filing status).

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[2] See Treas. Reg. § 1.409A-1(c)(2)(i); common categories of plans that must be aggregated include all elective account balance plans (*e.g.*, a DC SERP), all non-elective account balance plans (*e.g.*, a DC SERP), and all non-account balance plans in which a participant has a benefit (*e.g.*, a DB SERP).

[3] For more information on the IRS 409A correction program for operational failures, please see our prior Marketplace article Whoops - What to Do When You Discover an Operational Error in a Non-Qualified Deferred Compensation Plan *in the Resource Library.*

Wages are normally taken into account for FICA purposes when they are actually or constructively received, known as the "general timing rule."[4] However, Code Section 3121(v) and the related regulations impose a "special timing rule" for benefits under nonqualified deferred compensation plans, including SERPs.[5] In general, the special timing rule requires amounts under a SERP to be considered wages (and subject to FICA) at the earlier of (i) when the services required to create the legally binding right to compensation are performed or (ii) when the amounts are no longer subject to a substantial risk of forfeiture – even though this is before the date that benefits are actually or constructively received.

A "non-duplication rule" under the regulations provides that amounts taken into account for FICA purposes under the special timing rule do not need to again be considered at the time of actual or constructive receipt under the general timing rule.[6] Under the non-duplication rule, additional amounts that reflect a reasonable time-value of money on those wages taken into account under the special timing rule (such as amounts credited to an account balance plan based on a reasonable interest rate or a return based on a predetermined actual investment or adjustments in value due to the passage of time based on reasonable actuarial assumptions for a non-account balance plan) are considered to be included in the amount originally included as wages under the special timing rule and therefore are not further subject to FICA tax.

The special timing rule applies differently for "non-account balance plans," such as DB SERPs, and "account balance plans," such as DC SERPs. For a DB SERP, the special timing rule applies to vested benefits when the value of those benefits are "reasonably ascertainable." The benefits are "reasonably ascertainable" when the amount, form, and commencement date of the benefit payments under the DB SERP formula are known, and the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality. For DC SERPs, the FICA tax applies for the year in which the benefit is first vested.

The SERP document should include employer flexibility to determine exactly how FICA taxes are calculated and withheld. In *Davidson v. Henkel Corp.*, the SERP mandated a specific approach to calculating FICA taxes that the employer did not follow. A participant sued the employer, arguing that the SERP's stated procedure would have resulted in less total FICA taxes than the approach actually used by the employer.[7] The court, applying general contract law principles, found for the participant and ruled that the employer owed the participant the amount of excess FICA taxes that resulted from the failure to follow the specified SERP provisions.[8]

ERISA Compliance Key Issues

A SERP, whether a DB SERP or a DC SERP, is a form of "pension plan" for purposes of ERISA. As discussed in more detail below, there are three key ERISA-related compliance issues that need to be addressed for SERPs:

1. Eligibility needs to be limited to ensure that the SERP qualifies as a "top hat" plan;

[4] *See* Treas. Reg. § 31.3121(v)(2)-1(a)(1).
[5] *See* Treas. Reg. § 31.3121(v)(2)-1(a)(2)(ii).
[6] *See* Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii).
[7] See *Davidson v. Henkel Corp.*, 115 AFTR 2d 2015-369 (E.D. Mich. 2015).
[8] *Id*.

2. A one-time "top hat" filing needs to be made with the Department of Labor ("DOL"): and

3. The SERP should include ERISA-compliant claims procedures.

"Top Hat" Plan Status. Under ERISA, a "pension plan" means any plan or program that either (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of employment or beyond. Under ERISA, a SERP will generally be treated as a pension plan.

Pension plans under ERISA generally must comply with a number of substantive requirements, including minimum participation and vesting requirements and a requirement to fund plan benefits. Pension plans are also generally covered by ERISA's fiduciary duties. An ERISA "top hat" plan, however, does not have to satisfy these substantive requirements and is not subject to ERISA's fiduciary duties. A SERP generally must qualify as a top hat plan in order to provide for a deferral of compensation, because the SERP must be unfunded for tax purposes.

A top hat plan is an ERISA pension plan that "is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees."[9] The DOL has not provided a bright-line standard for defining what constitutes a "select group of management or highly compensated employees." Courts generally apply a mix of quantitative and qualitative factors to make the determination as to whether a covered group of employees qualify as a "select group of management or highly compensation employees" –

- **Quantitative measures**: generally, are focused on the percentage of an employer's workforce that is eligible to participate. Plans generally fall within an acceptable purview if participation in the plan is limited to less than 10% of the employee population.

- **Qualitative measures:** generally, are focused on the positions, duties, and compensation of those eligible to participate. Plans generally fall within an acceptable range if participation in the plan is limited to employees who have average compensation in excess of two-times the average compensation of the entire workforce.[10]

- Together, this means that eligibility for a SERP needs to be closely reviewed and limited. Some employers will base eligibility on the hierarchy within the leadership structure, such as the CEO and the CEO's direct reports. Other employers may desire to cover additional key employees, especially if the SERP will include vesting or other conditions intended to encourage retention or performance. In any event, the scope of coverage should be reviewed to ensure that the group covered can be characterized as a top hat group.

- **DOL Top Hat Filing**. Although SERPs, as ERISA top hat plans, are exempt from many of ERISA's substantive requirements, they remain subject to some of ERISA's reporting and disclosure requirements. These reporting and disclosure requirements include the requirement to file an annual Form 5500 with the DOL and IRS. DOL regulations, however, provide top hat plans with an easy exception from the Form 5500 requirement by filing a one-time top hat statement.[11]

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[9] *See* ERISA §§ 201(2), 301(a)(3) and 401(a)(1).

[10] For more information on top hat plan eligibility requirements, please see our prior Marketplace article "Top Hat" Plans — What are They and How Do You Know If You Have One" in the Finseca Resource Library.

[11] *See* 29 C.F.R. § 2520.104-23.

The top hat plan statement generally must be filed with the DOL within 120 days after a SERP is established. The top hat plan filing is a one-time requirement and only one statement is needed for each employer maintaining one or more top hat plans. The information included is simple and straightforward to complete. No filing fee is required. If timely filed, the SERP need not file annual Form 5500s and the employer need not provide participants with a summary plan description, summary of material modifications, or summary annual report.[12]

Top hat plan statements must be filed online through the Employee Benefits Security Administration's website.[13] Employers can file top hat statements for more than one plan at the same time, using a single statement covering all of the plans.

Claims Procedures. SERPS, like all ERISA top hat plans, are required to establish and maintain reasonable procedures governing the filing of benefit claims, notification of benefit determinations, and appeal of adverse benefit determinations (collectively, "claims procedures").[14] Generally, SERP participants are required to fulfill all of the required steps under the SERP's claims procedures before they may file a civil action against the plan; however, when a SERP fails to establish, or the employer fails to follow, the requisite claims procedures, a claimant is deemed to have exhausted the administrative remedies provided under the plan and may proceed straight to a civil action.[15]

In the event a claim is eventually brought in court, courts apply a deferential standard of review to the plan's administrator (assuming the SERP document includes a grant of discretion to that administrator), and that plan administrator's decisions will be overturned only if those decisions are arbitrary and capricious or constitute an abuse of discretion.[16] The application of such a favorable standard of review can make or break an ERISA claim for benefits that proceeds to litigation.[17]

If the SERP includes special benefits related to a participant's "disability," special ERISA claims procedures may need to be included in the SERP. Those special claims procedures include enhanced content requirements in case of a claim denial, expanded appeal rights, and expedited time frames for decisions and appeals. The special claims procedures would not apply, however, if the SERP's definition of "disability" is based on a determination of disability by the Social Security Administration or by the employer's long-term disability plan carrier. In these cases, there is not a discretionary determination regarding disability made by the SERP administrator.

Informal Funding

In order for SERP benefits to result in deferral of income taxation, and to qualify as a top hat plan for

[12] For more information about filing top-hat plan statements, please see our prior Marketplace article New Year Reminder: Have you Filed a Top Hat Plan Statement for Your Non-Qualified Deferred Compensation Plans? in the Finseca Resource Library.

[13] As of August 16, 2019, it is mandatory for sponsors of top hat plans to file top hat plan statements electronically via the Top Hat Plan Statements Online Filing System located here.

[14] *See* 29 C.F.R. § 2560.501-1(b)

[15] *See Miller v. Metro Life Ins. Co.*, 925 F.2d 979, 986 (6th Cir. 1991); 29. C.F.R. § 2560.503-1(l)(1)

[16] *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989) (establishing the principle that the amount of deference to be paid to a decision to deny benefits depends on a grant of discretion under the plan).

[17] For more information on top hat plan filings, please see our prior Marketplace article *entitled "The Importance of Claims Procedures in Nonqualified Deferred Compensation Plans* in the Finseca Resource Library.

ERISA purposes, benefits must be "unfunded and unsecured." This requirement means that a participant's right to vested benefits in the SERP can be no greater than the rights of a general creditor of the employer. Accordingly, the participant's SERP benefits must be at the risk of the employer's insolvency.

Unlike a tax-qualified retirement plan, assets cannot be set aside in a trust that is beyond the reach of the employer's general creditors. An employer may, however, establish a form of grantor trust known as a "rabbi trust" to hold and invest assets to be used to pay SERP benefits. While the rabbi trust assets must remain available to the employer's general creditors in the case of insolvency, those assets can provide a degree of benefit security prior to insolvency and can help the employer establish a financial hedge against those SERP liabilities. An employer might also set aside assets in a separate account for hedging SERP liabilities without use of a rabbi trust. Assets used to hedge liabilities in some cases could include life insurance policies on certain key employees – *i.e.*, "corporate owned life insurance" or "COLI."

Decisions about whether and how to informally fund SERP liabilities should be made in a collective manner with HR, tax, and accounting functions. Informally funding DB SERP liabilities may also require assistance from an actuarial firm to help determine the value of those liabilities.

Conclusion

A SERP can be an excellent tool to reward key employees for long service and create a competitive total compensation package that distinguishes an employer from its competitors. But there is no one-size-fits-all when it comes to SERP design. An employer thinking about adopting a SERP should clearly identify the intended business goals that the SERP will serve, and then work with its key advisors to create a SERP design to best meet those goals. The employer also needs to coordinate the necessary internal resources to ensure compliance in both form and operation with the requirements of ERISA, the Code, and any other applicable laws.