

The Executive Roth PlanSM: Securing the Benefits of SERPs

By William L. MacDonald and Kenneth A. Kirk

William L. MacDonald and Kenneth A. Kirk explain the Executive Roth Plan, drawing a comparison to some current corporate pay-as-you-go defined benefit SERP plans. This article indicates that the Executive Roth Plan can be adopted prior to December 31, 2008 and, because the conversion removes the retirement funding from a former defined benefit plan to a Roth type plan, will avoid the increased requirements of recent Code Sec. 409A revisions. The opinions expressed here are the authors' own and do not represent the opinion of CCH or any other party.

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Companies have a short window of time to analyze their nonqualified plans and react to changes in Code Sec. 409A before the end of the year. Many companies are finding the Executive Roth Plan an attractive update to their supplemental executive retirement plans (SERP). Typically, nonqualified retirement benefits provide more than 50 percent of an executive's retirement income. With competition fierce for attracting and retaining a quality executive team, and stringent new proxy reporting requirements, a well-designed nonqualified plan has never been more important. Executives are looking to their employers to offer nonqualified plans that provide for full security, tax efficiency, portability, and self-directed investments. Companies must balance those requirements with their responsibility to stockholders and the new governance and reporting requirements.

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This article provides perspective on the current situation based on the evolution of nonqualified plans, and introduces an innovative new plan, the Executive Roth Plan, which many companies are using to attract key talent, respond to the new benefit environment, and enhance shareholder value. This article also explains why it is essential to reevaluate your corporate plans and make desired updates before year-end.

Why Now Is the Time to Reevaluate Your Plans

In April of this year, the U.S. Treasury and the IRS issued final regulations for Code Sec. 409A that affect nonqualified plans. The changes to Code Sec. 409A create new restrictions on nonqualified arrangements and impose stricter reporting and disclosure guidelines. These new rules reduce the flexibility, security and appeal of many nonqualified arrangements. Although these restrictions were effective for all plans beginning January 1, 2005, IRS Notice 2007-86 provides for transitional relief until December 31,

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2008, giving companies a window of opportunity to amend plans and alter existing elections.

Before the end of the year (2008), the transition period permits companies to reevaluate plans and make necessary changes to meet the objectives of executives and the company. Many employers are reassessing the benefits of maintaining older SERP designs versus the advantages of restructuring plans into new options such as the Executive Roth Plan.

The Evolution of Nonqualified Retirement Plans

Over the past 20 years, restrictions on contributions and benefits from qualified retirement plans (*i.e.*, pension, 401(k), and profit sharing plans) prompted many companies to implement nonqualified retirement plans. Commonly, the plans were designed to help highly compensated executives receive the same benefit percentage from qualified and nonqualified plans as other employees would receive from qualified plans alone. Today, nonqualified retirement plans are a common benefit for many executives who earn more than \$125,000 annually.

Table 1 provides a comparison of highly compensated executives with those earning less than \$125,000.

As companies designed attractive executive compensation programs, numerous supplemental retirement plans and other executive benefits programs were developed, including:

- Defined Benefit Excess and Restoration Plans
- Deferred Compensation Plans

- 401(k) Excess Plans
- Split Dollar and SERP Swap Plans
- Executive Retiree Medical Funding Plans

Defined benefit (DB) pension plans became a staple of corporate retirement delivery. However, DB plans (and DB SERPs) began to lose favor due to the popularity of 401(k) plans. In addition, the pension-funding crisis (2002–2003), plan volatility, and the financial strain of the DB approach also led companies to rethink their DB plans. Consequently, many qualified DB plans were updated to cash balance and/or modified to preferred compensation approaches. On the nonqualified side, many DB SERPs are still in place and have not been redesigned to meet the new objectives of plan participants, 409A, or new alternatives available in the market.

The New Regulatory and Tax Environment: The Current Tax Environment

The original premise of nonqualified plans was to not only restore benefits and contributions, but also to defer taxation until retirement when tax rates would presumably be lower. However, today's current low income tax rates expose many executives to an over-concentration of tax rate deferral risk.

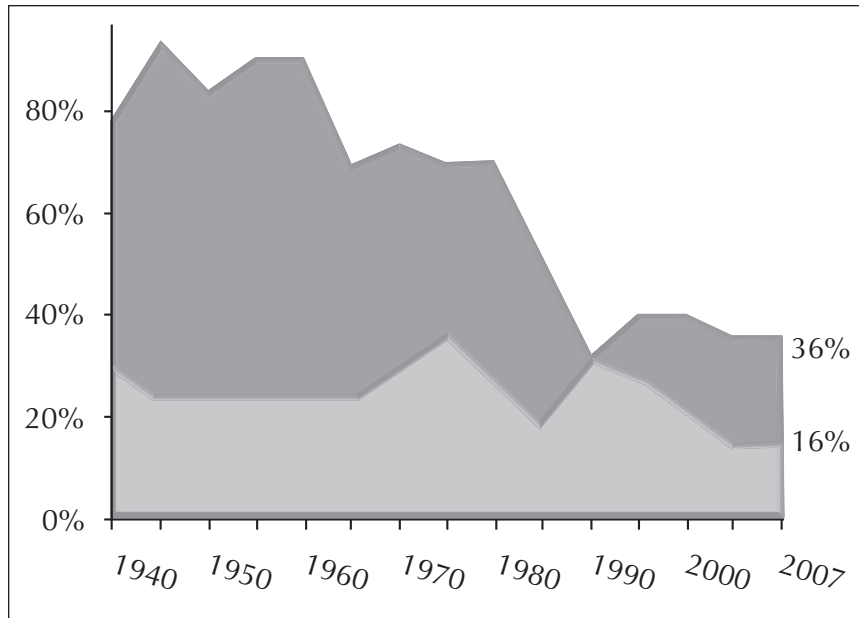
Table 2 shows that combined marginal income and capital gains tax rates are at the lowest point in over 60 years. Many believe that it is safe to assume that tax rates will increase, with at least one tax increase

Table 1. Impact of Retirement Plan Limits on Executives

Participant	Final Average Salary	Pension	SERP	SERP as % of Total DB Benefit
Executives:				
Executive 1	\$2,000,000	\$115,000	\$1,285,000	92%
Executive 2	1,000,000	115,000	585,000	84%
Executive 3	500,000	115,000	235,000	67%
Executive 4	250,000	115,000	60,000	34%
Rank and File:				
Employee 1	100,000	50,000	0	0%
Employee 2	75,000	37,500	0	0%

- Retirement Age: 65
- Total Service at Retirement: 25 Years
- DB Plan Formula: 2% x YOS (max 25 years) x Final Average Compensation
- SERP: 70% of final average compensation less qualified plan benefit

Table 2. Top Marginal Income and Capital Gains Tax Rates



Nonqualified plans escaped current taxation as long as participants were exposed to a substantial risk of forfeiture, were not secure from corporate insolvency, and participants did not possess too much control over the deferrals, receipt, and informal funding of the benefits.

However, the NQ market became very sophisticated and progressively transferred greater control and security to executives through:

- “haircut” provisions,
- executive discretion over distributions,
- financial triggers,
- self-directed brokerage accounts, and
- offshore funding to protect against solvency risk.

already scheduled for 2010, and even higher rates likely on the horizon.

As a result of our current low income tax rate environment, many companies and executives do not want to defer compensation into traditional plans. There has been a dramatic drop-off of deferred compensation contributions over the last several years, and many are interested in redesigning or replacing their plans with new plans designed to optimize the low tax rates.

In addition to the progressively increasing control and security executives enjoyed, Enron, WorldCom, and perceived executive compensation abuses attracted greater visibility to NQ retirement plans. In response, new regulations and legislation affecting NQ plans have been either made or proposed, and intensified corporate governance was extended to NQ plans.

These new regulations have reduced the advantages of many existing nonqualified plans including DB SERPs:

Table 3. Congressional, IRS, SEC and FASB Regulations

Sarbanes-Oxley <ul style="list-style-type: none"> • No personal loans to officers • No offshore Rabbi Trusts 	Split Dollar Regulation <ul style="list-style-type: none"> • Eliminated collateral assignment • Redefined restrictive Split Dollar taxation/methodology
American Job Creations Act: 409A <ul style="list-style-type: none"> • Reduced flexibility on deferral elections • No “haircut provisions” (accelerate distributions) • Delayed payouts for key executives • Limiting financial triggers 	FASB/EITF Ratifications <ul style="list-style-type: none"> • Endorsement Split Dollar • COLI accounting • Stock Option Expensing
Pension Protection Act <ul style="list-style-type: none"> • Penalties on non qualified funding • COLI “best practices” 	SEC <ul style="list-style-type: none"> • Increased disclosure requirements
	Pending Legislation <ul style="list-style-type: none"> • New caps on NQ annual deferrals/accruals • Expansion of 162(m) limitations

Recent Regulatory Actions

During the 1990s, nonqualified plans began to attract IRS/Congressional attention as the plans evolved to broader participation, provided significantly increased benefits, and became substantially funded.

- With new proxy disclosure rules, SERPs have become more visible and problematic for companies.
- Newly enacted Code Sec. 409A changes significantly diminished the security of SERP agreements and funding arrangements.

Table 4.

SERP Formula:	60% of Final Average Salary payable for 15 years certain
Executive Roth Plan Formula:	Target insurance values to annually settle SERP ABO. Policy cash values are invested to provide nontaxable withdrawals and loans equal to the after-tax equivalent SERP payments. After tax equivalence assumed at 35% retirement tax rate.
Sample Executive:	Age: 53 Current Salary: \$515,967 Retirement Age: 65 Projected SERP: \$476,584 per year (4% salary increase each year) Present Value of After tax SERP at 65: \$3,376,180 (5% discount rate)
Currently Accrued SERP:	\$1,735,300 Assumes reversal over remaining service may be possible to reverse over a shorter term.
FAS87 Discount Rate:	5%
Corporate Tax Rate:	40%
Executive Tax Rate:	Current 35% increasing to 40% in 2010
Insurance Policy Investment Return:	7% net of asset management fees
Premium Payment Period:	Remaining working service premium changes can be used to readjust funding for asset/liability matching due to changes in actuarial assumptions or investment performance.
Insurance Contract:	Lincoln Variable Universal Life with Alternative Loan Rider.

Table 5. Executive Perspective

Age	Baseline PAYG SERP			Executive Roth Plan				Executive Net Death Proceeds	
	SCRP Payment	Tax Paid	Net Benefits	SERP Settlement Bonus	Tax Paid	Net ERP Contribution	Net Benefits*		Executive Cash Value
53				295,058	-103,270	-191,788		221,128	3,947,541
54				295,058	-103,270	-191,788		443,202	3,838,300
55				295,058	-103,270	-191,788		676,315	3,725,782
56				295,058	-118,023	-177,035		920,649	3,609,888
57				295,058	-118,023	-177,035		1,188,569	3,490,472
58				295,058	-118,023	-177,035		1,456,607	3,449,980
59				295,058	-118,023	-177,035		1,747,967	4,039,843
60				295,058	-118,023	-177,035		2,041,202	7,066,590
61				295,058	-118,023	-177,035		2,373,837	6,932,149
62				295,058	-118,023	-177,035		2,738,379	6,793,762
63				295,058	-118,023	-177,035		3,138,843	6,651,223
64				295,058	-118,023	-177,035		3,568,632	7,107,807
65	476,584	-190,634	285,950				309,780	3,513,467	7,057,488
66	476,584	-190,634	285,950				309,780	3,462,012	7,006,256
67	476,584	-190,634	285,950				309,780	3,417,578	6,959,085
68	476,584	-190,634	285,950				309,780	3,371,954	6,726,443
69	476,584	-190,634	285,550				309,780	3,325,500	6,500,652
70	476,584	-190,634	285,950				309,780	3,271,781	6,271,441
71	476,584	-190,634	285,550				309,780	3,213,537	6,043,551
72	476,584	-190,634	285,550				309,780	3,153,799	5,821,856
73	476,584	-190,634	285,550				309,780	3,097,879	5,614,414
74	476,584	-190,634	285,550				309,780	3,034,343	5,405,419
75	476,584	-190,634	285,550				309,780	2,968,641	5,202,890
76	476,584	-190,634	285,550				309,780	2,904,841	5,011,889
77	476,584	-190,634	285,550				309,780	2,844,342	4,833,343
78	476,584	-190,634	285,550				309,780	2,782,089	4,659,236
79	476,584	-190,634	285,550				309,780	2,723,624	4,545,349
80							4,794,229		4,794,229
Total	7,148,760	-2,859,510	\$4,289,250	3,540,696	-1,372,017	-2,168,679	\$9,440,229		

Corporate Reactions to the New Environment

Companies are reacting to these new regulatory constraints by:

- Amending plans to comply with Code Sec. 409A (e.g., eliminating “haircut” provisions, distribution discretion)
- Modifying proxy disclosure
- Eliminating or phasing out Executive Split Dollar plans
- Eliminating qualified DB plans and analyzing what to do with nonqualified DB SERPs
- Reducing contributions to or eliminating Rabbi Trusts
- Analyzing methods to reduce and diversify executive tax-rate deferral risk
- Implementing alternative deferred compensation plan options
- Updating DB SERPs with conversion to DC approaches or the after-tax Executive Roth Plan option

The Executive Roth Plan

The qualified Roth 401(k) was introduced in January 2006. Just a little more than a year after its implementation, the Roth 401(k) has now become a viable, permanent fixture in the retirement planning toolkit. Many employers have adopted the Roth 401(k) to work in concert with their 401(k) plan. The Roth 401(k) option provides participants with the flexibility of using after-tax income to save for retirement, which allows them to make nontaxable distributions. However, contributions are restricted and many executives are limited on what they can contribute.

RCG/Vinings has designed an innovative new plan called the Executive Roth Plan. The

Executive Roth Plan is an after-tax arrangement that companies are using to modify and update existing defined benefit SERPs. For example, it can be structured based on performance goals or continued employment to a specified age for eligibility.

From the company’s perspective, the Executive Roth Plan:

- Provides an enhanced, more meaningful plan to participants, while reducing corporate cost
- Can significantly reduce the P&L cost of the plan
- Lowers the net present value cost of the plan
- Maintains retention objectives of original SERP
- Enhances ongoing recruitment versus peers who do not adopt before year end

Table 6. Corporate Cash-Flow Comparison

Age	Baseline PAYG SERP			Executive Roth Plan		
	SERP Payment	Tax Savings	Net Outlay	SERP Settlement Bonus	Tax Savings	Net Outlay
53				-295,058	118,023	-177,035
54				-295,058	118,023	-177,035
55				-295,058	118,023	-177,035
56				-295,058	118,023	-177,035
57				-295,058	118,023	-177,035
58				-295,058	118,023	-177,035
59				-295,058	118,023	-177,035
60				-295,058	118,023	-177,035
61				-295,058	118,023	-177,035
62				-295,058	118,023	-177,035
63				-295,058	118,023	-177,035
64				-295,058	118,023	-177,035
65	476,584	-190,634	285,950			
66	476,584	-190,634	285,950			
67	476,584	-190,634	285,950			
68	476,584	-190,634	285,950			
69	476,584	-190,634	285,950			
70	476,584	-190,634	285,950			
71	476,584	-190,634	285,950			
72	476,584	-190,634	285,950			
73	476,584	-190,634	285,950			
74	476,584	-190,634	285,950			
75	476,584	-190,634	285,950			
76	476,584	-190,634	285,950			
77	476,584	-190,634	285,950			
78	476,584	-190,634	285,950			
79	476,584	-190,634	285,950			
80						
Total	7,148,760	-2,859,510	\$4,289,250	-3,540,696	1,416,278	-2,124,420
	NPV @ 6% Gross		-2,139,171			-1,700,723
	NPV @ 6% Gross		-2,394,273			-1,762,206

- Is not subject to new rules imposed by Code Sec. 409A
 - Has little or no ongoing corporate accounting, administration, or record-keeping requirements
- From the executive's perspective, the Executive Roth Plan:
- converts a DB plan to a defined contribution, account balance approach where the executive directs investments and controls distributions;
 - Offers a strategy for improved retirement tax planning and enhanced after-tax benefits
 - Secure from corporate creditors and takeovers
 - Allows for supplemental pre- and post-retirement contributions
 - Converts the entire SERP benefit to an income tax-free, and possibly estate tax-free, benefit

Comparison of ERP and DB SERP

The best way to evaluate the Executive Roth Plan is to look at an example. The tables throughout this article provide a comparison of a Corporate Pay-As-You-Go Defined Benefit SERP and the Executive Roth Plan.

Summary

Code Sec. 409A rules reduce the flexibility, security, and appeal of many existing plans. The Executive Roth Plan is not subject to these new restrictions, but must be implemented prior to December 31, 2007, in order to take advantage of the transition period. Because of this short transition timeline, we are finding many companies currently reevaluating their plans.

Table 7. Corporate P&L Comparison

Age	Baseline PAYG SERP					Executive Roth Plan				
	FAS87 Service Cost	Interest Cost	Total Accrual	Deferred Tax Savings	Net P&L Impact	SERP Settlement Bonus	Tax Savings	SERP Reversal	Reversal: SERP Def. Tax	Net P&L Impact
Prior			1,735,000	-694,000	1,041,000					1,041,000
53	124,353	92,968	217,321	-86,928	130,393	295,058	-118,023	-144,583	57,833	90,285
54	124,353	103,834	228,187	-91,275	136,912	295,058	-118,023	-144,583	57,833	90,285
55	124,353	115,243	239,596	-95,838	143,758	295,058	-118,023	-144,583	57,833	90,285
56	124,353	127,223	251,576	-100,630	150,946	295,058	-118,023	-144,583	57,833	90,285
57	124,353	139,802	264,155	-105,662	158,493	295,058	-118,023	-144,583	57,833	90,285
58	124,353	153,009	277,363	-110,945	166,418	295,058	-118,023	-144,583	57,833	90,285
59	124,353	166,878	291,231	-116,492	174,738	295,058	-118,023	-144,583	57,833	90,285
60	124,353	181,439	305,792	-122,317	183,475	295,058	-118,023	-144,583	57,833	90,285
61	124,353	196,729	321,082	-128,433	192,649	295,058	-118,023	-144,583	57,833	90,285
62	124,353	212,783	337,136	-134,854	202,282	295,058	-118,023	-144,583	57,833	90,285
63	124,353	229,640	353,993	-141,597	212,396	295,058	-118,023	-144,583	57,833	90,285
64	124,353	247,339	371,692	-148,677	223,015	295,058	-118,023	-144,583	57,833	90,285
65		235,877	235,877	-94,351	141,526					0
66		223,842	223,842	-89,537	134,305					0
67		211,204	211,204	-84,482	126,723					0
68		197,935	197,935	-79,174	118,761					0
69		184,003	184,003	-73,601	110,402					0
70		169,374	169,374	-67,750	101,624					0
71		154,013	154,013	-61,605	92,408					0
72		137,855	137,855	-55,154	82,731					0
73		120,950	120,950	-48,380	72,570					0
74		103,168	103,168	-41,267	61,901					0
75		84,497	84,497	-33,799	50,698					0
76		64,893	64,893	-25,957	38,936					0
77		44,308	44,308	-17,723	26,585					0
78		22,694	22,694	-9,078	13,617					0
79										0
80										0
Total	1,492,236	5,719,514	7,148,750	-2,859,500	\$4,289,250	3,540,696	-1,416,276	-1,735,000	694,000	\$2,124,420

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