John Hancock INSURANCE

Supplemental Executive Retirement Plans

CLIENT SNAPSHOT

BUSINESS PLANNING

A retirement benefit for key executives funded by the employer

In today's highly competitive business environment, you may find it difficult to attract, reward, and retain talented employees. Choosing key executives to participate in a non-qualified plan such as a Supplemental Executive Retirement Plan (SERP) can be an excellent way to reward and retain top talent.

A SERP is an employer-sponsored non-qualified deferred compensation plan that allows you to provide your best employees with additional retirement benefits beyond those offered by qualified plans (401(k), IRA, etc.). Through a SERP, you can help your key employees achieve their retirement goals and alleviate their worries of having a retirement income shortfall.

A SERP is financed solely through business contributions – the employee does not contribute to the plan.

How it Works

STEP 1 – IDENTIFY THE KEY EMPLOYEES

The first step is to determine which key employee(s) you would like to participate in the plan. Because a SERP is not subject to the discrimination rules associated with qualified plans, you are free to reward select employees in varying amounts and participation levels and are not required to offer the SERP plan to all employees.

LIFE-7555 1/18

STEP 2 – EXECUTE THE AGREEMENT

You and the participating employee enter into an agreement, whereby (A) you promise to pay the employee income in the future (e.g., at retirement); and (B) the employee agrees to continue working for you for a period of time. The amount of the future income may be contingent upon a variety of factors that you select, such as the length of service of the employee, the profitability of the business, and the amount of total compensation the employee currently receives.

The contract will specify how the future SERP benefit amount will be determined and when it will be paid. Consider:

- *How do you want contributions to be structured?*
  - **Option 1:** "Defined Contribution." You credit specific dollar amounts annually to the employee's SERP account (plus interest).
  - **Option 2:** "Defined Benefit." You promise to pay the employee an amount of annual income based on: 1) a flat dollar amount (e.g., $100,000); 2) a percentage of salary (e.g., 50% of final salary); or 3) a formula (e.g., 50% of the average of the employee's final three years of salary) at retirement.
- *Do you want to include a survivor benefit?* SERP plans typically 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. A separate, additional death benefit component can be built into the plan during the employee's pre-retirement years.

STEP 3 – EXPLORE VESTING OPTIONS

You can choose to place a vesting schedule on the plan, which can act as a "golden handcuff" to encourage the employee to stay with your company on a long-term basis. If a vesting schedule is in place, the employee typically will be required to remain employed with you for a minimum duration of the vesting period to receive income benefits under the plan. If the employee terminates employment early, he may receive either a reduced benefit or no benefit depending on the terms of the vesting schedule.

STEP 4 – PAYMENT 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.

Funding the Plan

Although a SERP plan may be informally funded in several ways, many employers choose to use a permanent life insurance policy on the life of the key employee to help pay the future benefit payments and to recover costs of the plan. 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.[1]

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

A life insurance policy can be customized to address multiple needs:

1. For the employee, it can help provide a pre-retirement death benefit.
2. For the business, the life insurance can also provide additional key person death benefit protection.

Other funding options that you may consider are:

SELF-FUND

The benefits are paid from the current cash flow of your business at the time the benefits are payable. This can place stress on your business cash flow at that time. There is a risk the available cash flow will not be adequate to provide the SERP benefits, perhaps creating a lack of confidence among the plan participants.

SINKING FUND – MARKETABLE SECURITIES/ MUTUAL FUNDS

A reserve or sinking fund is set up whereby cash is invested. The business assumes the market risk and may need to invest in high-risk assets to meet the future obligations. Additionally, the business must pay taxes on the annual income earned.

ANNUITIES

The SERP benefits owed to a key employee are taken from the annuity. However, business entities cannot achieve income tax deferral with deferred annuities.

Key Benefits

FOR YOU

- **Flexibility:** Freedom to select which employees will participate in the plan and to determine the benefit provided to each employee.
- **Golden handcuffs:** You may impose a vesting schedule, which creates "golden handcuffs," giving the executive an incentive to stay employed with your business.
- **Cost recovery:** When informally funded with life insurance, the death benefit is generally received income tax free and can provide plan cost recovery.
- **Future deduction:** The business receives a tax deduction at the time the retirement benefit is paid.

FOR YOUR KEY EMPLOYEE

- **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:** Employee 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]

Important Considerations

- **Income Taxation:** The benefits received under a SERP plan will generally be taxed to the employee as ordinary income when received. At that time, your business will receive an income tax deduction for the benefit paid to the employee. If the plan is informally funded with life insurance, the premiums your business pays are not deductible.
- **Insurance Ownership and §101(j):** When life insurance is owned by an employer on the life of an employee, §101(j) of the tax code requires that certain conditions and Notice and Consent requirements be met to keep the death benefit proceeds income tax-free. Consult your tax/legal advisors for more information.[3]
- **Creditors:** If your business becomes bankrupt and is unable to pay the SERP benefit, the employee would be considered a general creditor of your business and would not receive preferential treatment in recovering the SERP benefit.
- **ERISA:** The possible application of ERISA should be considered for all non-qualified executive plans, including a SERP. In most instances, a SERP may be exempt from most ERISA requirements as a "top hat" plan.[4]
- **§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. Failure to comply with Section 409A may subject the employee to immediate income taxation of the deferred amounts, as well as interest and a 20% excise tax on the taxable income.

Conclusion

A SERP can be a great way to reward a key employee's hard work and loyalty to your 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 you with maximum control (i.e., "golden handcuffs") because nothing is paid to the employee unless he/she meets the years of service requirements as set forth in the plan. If you are looking to provide extra incentive to key employees, a SERP plan may be the perfect addition to your employee's total compensation package.

Talk to your financial professional to determine how a Supplemental Executive Retirement Plan might work for your business.

1. 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.
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. 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.

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Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2.

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