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SERPs in Public Corporations - Problems & Solutions

By Roy W. Craik

Supplemental Employee/Executive Retirement Plans (SERPs) are now common in most public corporations. In the 2008 Towers Perrin SERP Report, 88% of public corporations have a SERP. In their simplest form, they can be nothing more than a letter promising to make additional "pay-as-you go" benefits on retirement. Historically, SERPs covered the difference between the total "pension promise" under the pension formula and, benefits allowed under Defined Pension Plans (DPPs). SERPs sometimes topped-up pension benefits of retired employees to maintain status quo with current retirees. Today, they are also used to cover inequities under Money Purchase Pension Plans (MPPPs) and Group RRSPs.

Until recently, Employees/Executives were very accepting of SERP letters or SERP top-ups with little thought given to the underlying deferred cash flow liability and protection offered. A string of high profile corporate bankruptcies, and takeovers have changed that thinking.

Problems

For Employees, many have learned the hard way, that SERP letters offer little, if any, protection in the event of the Employer's bankruptcy. As well, post-retirement plans could be in jeopardy from, ownership changes, future management or Board.

For Shareholders, they are becoming increasingly aware of the substantial future cash flow liabilities SERPs generate.

For CRA, there is concern that SERPs are being used to disguise what they view as a Salary Deferral Arrangement (SDA) and, not as a Supplemental Pension under current guidelines.

Benefit Concerns

For most Employees/Executives, their total pension promise is a critical component in long term retirement planning. Many investment decisions (plans perhaps for a secondary retirement residence) rely on the combined retirement cash flow from both RPPs and SERPs and on the assumption that total benefits are secure.

For high earners, this can be even more critical as SERP benefits often provide the majority of their total pension. As an example, the indicated pension entitlement for someone with final average "pensionable earnings" of $300k might be 70% (35 years of service at 2%) or $210,000 annually. However, under current 2011 levels the Defined Benefit RPP payout would be approx. $89,327 ($2,552.22 per year of service). Even though Defined Benefit payouts are increasing annually, these increases are not sufficient to reduce the "pension gap" for high earners (those above $125,000 to $150,000 annually). In this case, the exposed SERP benefit is approximately $120,000 annually or 57% of the total pension promise. The loss could be catastrophic for the Employee/ Executive.

It is both unreasonable and unacceptable for any retiree to have to live with this uncertainty. As recent times have shown, many have suffered by the flameout of their former employer, some thought "to big to fail".

Shareholder Awareness

SERPs have largely been off the radar relative to shareholder activism. The cash flow liability for SERP payments defers well into the future and, is not an apparent threat to current shareholder value. This does not mean shareholder concerns will not surface in the future.

For many companies, SERP liabilities can run into the hundreds of millions and will likely become of increasing concern.

SERPs as SDAs

The proper use of a SERP is to provide Supplemental Pension Benefits relative to entitlements under "generally accepted guidelines" fully integrated with benefits from other Registered Pension Plans (RPPs). Most corporations offer pensions based on 2% per year of service (max 35 years) x final average "pensionable earnings". Exceeding these guidelines and, pushing "pensionable earnings", can result in the Canada Revenue Agency determining that the SERP is a Salary Deferral Arrangement (SDA).

Cash Flow & Accounting

Although accounting rules require the disclosure of SERP liabilities, actual cash flow costs and tax credits are deferred to the future (perhaps to a next generation of shareholder) which, will impact operating income at that time. Failure to understand this can lead to unfortunate results.

It would be difficult to dispute the necessity of SERPs in attracting and retaining talented Employees/Executives. However, it is important to properly manage and account for the SERP. In recent CCAA proceedings, those in SERPs secured by RCAs fared well. Those in "pay-as-you-go" SERPs lost benefits.

RCAs

Using the Retirement Compensation Arrangement (RCA) provisions of the Income Tax Act (Sec 248(1)), can provide security of SERP promises. Failure to use the RCA to at least secure SERP promises could expose Directors (aware of SERP promises) to liability, for the subsequent failure of the SERP to provide required benefits.

Pre-Retirement Funding

The liabilities for Registered Pension Plans (Defined Benefit & Money Purchase) are funded in advance of retirement under regulated guidelines. One could therefore argue that SERP benefits, covering the "Pension Gap", should also be funded concurrently with RPPs.

If it were not for an impediment in the RCA legislation, SERP benefits likely would be pre-funded.

The impediment is relative to the requirement that 50% of all RCA contributions and annual investment earnings (the latter unless tax-sheltered) be transferred to what is referred to as the Refundable Tax Account (RTA) held by CRA. As well, there is no differentiation between capital gains, dividend or interest income. Unfortunately, the RTA does not earn interest which, is problematic given much lower corporate tax rates.

Until required contributions to the RTA are reduced to closer match current corporate tax rates, many companies will continue not to pre-fund RCAs. The concern is the loss of Internal Rate of Return on excess contributions to the RTA.

Managed SERPs

The solution to these concerns is the establishment of a Managed SERP Programme. Such a plan offers:

- Full security of SERP benefits
- Fairness to Shareholders
- Protection against deemed SDA
- RTA mitigation

Security for Employees / Executives

Step one in a Managed SERP is, the actual establishment of an RCA. No pre-retirement security of SERP benefits is possible otherwise. Once established, Letters of Credit (LC) secure the RCA liabilities. This largely negates the RTA impediment. Cash contributions to the RCA are only the cost of buying the LC plus the matching amount to the RTA.

If a company is unable to secure the required LC from their bank, this should be of great concern to the Employees/Executives covered by the SERP along with the Company Directors. It is a strong indication that the RCA should be pre-funded annually notwithstanding, the inequities of RTA transfers. The LC offers pre-retirement protection. This is most important for those near retirement. In the unfortunate event that the company ends up in the CCAA process, the LCs secure benefits.

"In-pay" benefits receive protection by Terminal Funding contributions to the RCA at retirement, (as determined by the company actuary and the RCA 3rd Party Provider). If this is not done, a portion of the LC is called.

Fairness to Shareholders

The advantage of using LCs to secure SERP benefits to retirement is that, the cost is marginal relative to the IRR on funds otherwise required to secure benefits. The actual cash cost of funding benefits is deferred to retirement.

Even though the liability for SERPs are accounted for on an accrual basis, actual tax credits only materialize with contributions to the RCA or as benefits are paid. The actual cash flow cost to shareholders is the net "lump sum" contribution required to secure benefits for the retiring Plan Member.

Although SERP benefits are now expected to retain key Employees/Executives over the long term and, address RPP inequities, press reports of what some see as overly rich SERP packages are now attracting attention and comment:

- Why should shareholders pay when their own pensions are inadequate?
- Should they be paid for as the liability is incurred?

One solution to these concerns is to establish the Managed SERP in conjunction with a SERP Cost Recovery Plan using Corporate Owned Life Insurance (COLI) in a Special Purpose Subsidiary (SPS). COLI is used extensively in the US for SERP funding.

SERP Cost Recovery Plan

Step two is a SERP Cost Recovery Plan established in tandem with a Managed SERP. Employees/Executives receive security of the "Pension Promise" and, in return, help mitigate the cost of funding by allowing the Special Purpose Subsidiary (SPS) to purchase COLI products on each Plan Member (or groups of Plan Members for uninsurables), relative to the net cost of providing SERP benefits. Mitigation results in two ways:

- As Plan Members die, the SPS receives benefits from the COLI policies and pays a Capital Dividend to the Operating Company relative to the net SERP costs (including repayment of premium loans to SPS) for each employee / executive.
- The SPS finances net terminal funding contributions to the RCA as members retire, thus reducing SERP costs to the net interest on financing, a substantial reduction over "pay-as-you-go" costs. Over time, excess surplus builds in the SPS because of earlier mortality and, the value of the COLI policies increase as the SERP Plan Members age. The SPS loans are repaid over time from Capital Dividends paid to the Operating Company from the SPS.

Prior to 1986, COLI plans in Canada mitigated the cost of SERP funding. However, they offered no protection in the event of bankruptcy. Now with the establishment of the LC funded RCA, a Managed SERP can offer full security and, the SERP COLI held in the SPS provides shareholder recovery.

SERP Mortality Funding

It is possible to draw an actuarial line whereby, benefits for SERP members on one side terminate, before/at retirement of SERP Members on the other. As such a SERP Cost Recovery Plan can be used to further reduce the costs of SERP funding by increasing the size of the SPS COLI policies on selected members. The time horizon for SERPs in most public corporations is infinite. **Utilizing the tax and yield advantages of a Participating Pool of a large insurance company over the same time frame can thus be very advantageous to shareholders by further mitigating net SERP funding costs.**

For established annually funded RCAs, insurance within the RCA can mitigate the cost of both primary and survivor benefits.

COLI & Accounting

For COLI Plans to be effective, they should, over time be balance sheet neutral with, little or no effect to P & L. The required "cash to cash value" transfer of assets by purchasing of notes issued by the Special Purpose Subsidiary is achieved if the insurance company IRR at least equals the corporation's net earnings on funds transferred. Providing the COLI policies are properly structured (a cash value at retirement equal to net terminal funding RCA costs), this is obtainable through the Participating Accounts of major insurers. As an example, (based on 25 year averages ending in 2009 provided by Sun Life Financial), the average dividend interest rate was 9.3% as compared to the S&P/TSX Total return of 9.3% and the 10-year GOC bond of 7.1%. (Source: Sun Life Participating Account brochure #810-3599-06-01). The standard deviation was 1.3% against the S&P/TSX Total return of 16.4% and the 10-year GOC bond was 2.3%. Considering the time horizon for SERPs, these are acceptable returns.

SDA Mitigation

A concern with SERPs is that the Income Tax Act allows for RCAs to be deemed Salary Deferral Arrangements (SDA) if entitlement, integration and, funding guidelines are not followed. Unfortunate and expensive tax consequences can result. Managed RCAs can largely eliminate these concerns if RCA Ledgers (done a triennial basis) properly track benefits for each Plan Member relative to CRA guidelines.

SERP benefits and obligations are in the documentation, which can be nothing more than a forgotten letter in someone's file. Oftentimes, this documentation can lead to other problems. Some letters (in conjunction with Retirement Minutes) allow the SERP member the "option" to take benefits in a lump sum or, over time as a retiring allowance, thus inviting an SDA attack.

SERP documentation must involve Corporate Counsel with Pension/SERP expertise and, be reviewed on a regular basis.

SERP Valuations

Sometimes forgotten SERP letters surface when an accounting firm asks to determine if the cost of funding was "meaningful". Many companies are surprised at the total liability when all the letters are collected and valued.

Unfunded and/or forgotten SERPs no longer escape the attention of M & A Practitioners. A clearly defined Managed SERP programme can save a lot of grief down the road.

Summary

Even if security is not an issue (chartered banks for example), "pay-as-you-go" SERPs are more costly to shareholders than a Terminally Funded (utilizing net financing) RCA Funded SERP combined with a Corporate Employee Recovery Plan through a SPS funded by COLI.

There is also less chance that SERPs for high-earners, now governed by letters and Board resolutions, are challenged as SDAs. Some SERPs are now under the watchful eye of the press. A properly Managed SERP programme with clearly defined benefits for each Employee/ Executive class can do much to mitigate negative coverage.

In recent years, there was more focus on bonus compensation than SERPs. In the years ahead, SERPs will see equal or more focus. They are critical to the retirement of most executives and, certain to attract more shareholder attention.

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