An Educational Guide for Business Owners

Guardian®

Protect Your Top Performers' Financial Future and Your Business

With a Supplemental Executive Retirement Plan

If You Have Key Employees You Want to Retain for the Long Term...

you may wish to consider implementing an executive benefit program that will help to protect their financial future, while protecting your company with a solution that can help to ensure their loyalty for years to come.

Is this strategy right for you?

You may wish to consider implementing this technique if your business:

- Is a medium-size or large closely held or publicly traded company that is well established and financially strong; and
- Wishes to attract, retain and reward highly productive "key" employees; and
- Wishes to provide a retirement benefit that helps to compensate the selected key employees for the "reverse discrimination" they are subject to by qualified plan limitations, and one that will help to ensure that they remain with your company for the long term.

Why Your Top Performers May Be Worried About Their Financial Future

Highly compensated employees often share a common problem: government-imposed caps on qualified plan contributions make it hard for them to save enough for retirement. And, if they participate in a defined benefit plan, those same rules can make it hard for them to qualify for a high enough pension benefit to support their lifestyle when they are no longer working. This is often referred to as "reverse discrimination."

How reverse discrimination works against top earners

The table below shows how qualified plan limits can result in a form of reverse discrimination for highly compensated individuals. The graphic on the right below shows you how much retirement income a hypothetical key employee, Jane, could lose out on with respect to retirement income due to these limits.

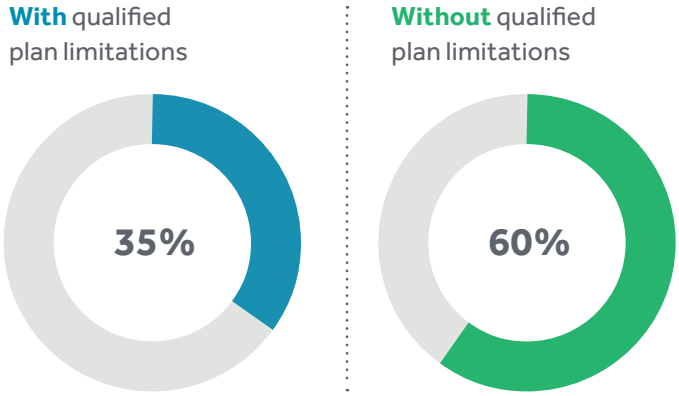
Jane's company offers a defined benefit pension plan that provides a benefit equal to 60% of her average compensation during her last three years of employment before retirement. Jane earns $375,000. The problem? Due to the IRS's $220,000 limit on compensation that can be considered for defined benefit plan participants, Jane will receive just $132,000 per year in retirement (60% of $220,000) rather than $225,500 (60% of her actual salary of $375,000). That means Jane will wind up with a monthly benefit that is only 35% of her average pre-retirement earnings, rather than 60%.

2019 Qualified Plan Limits

Category	Limit
Highly compensated employee status	$125,000
Includable compensation limit	$280,000
Defined benefit annual limit	$225,000
Contribution limit for defined contribution plans	$56,000
Maximum employee contribution to qualified plans	$19,000

Jane's problem: Jane makes $375,000 a year. Her company offers a defined benefit plan for 60% of the average of the final 3 years' pay.

Jane's retirement



Using a Supplemental Executive Retirement Plan (SERP) to bridge the retirement income gap

One executive benefit program that many business owners have found can help key employees overcome the effects of reverse discrimination is a Supplemental Executive Retirement Plan (SERP). With a SERP, your business can recruit, retain, reward and retire a select group of key employees. And a SERP can be designed to provide pre-retirement death benefits, post-retirement income, or both. For your key employees, a SERP can be used along with, or in lieu of, a qualified retirement plan.

How a SERP Works

1. The employer enters into an agreement with the key employee, where the employer agrees to provide specified retirement and death benefits. These benefits may be based on a flat amount, a percentage of salary, or any other formula to which both parties agree.

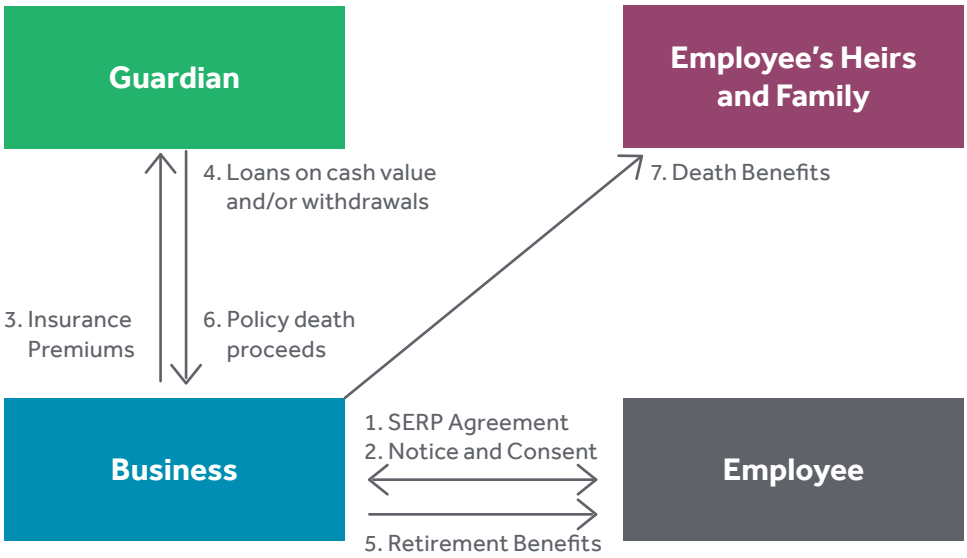
2. The employer provides the key employee with the proper notice required by law, and obtains consent that the business can and will take out a life insurance policy on the employee. The business also provides notice of the plan to the U.S. Department of Labor, Employee Benefit Security Administration.

3. The promise to pay benefits is required to be unsecured and unfunded. "Unfunded" means that a business may not isolate assets to be used solely for payment of the benefit. However, many businesses choose to "informally" fund their commitment through the use of business-owned permanent life insurance, which may be used for other business purposes besides funding this benefit. This provides a level of comfort to the employee that the business has the resources to pay the benefit. The business will be the applicant, owner, beneficiary and premium payor of the policy on the employee's life.

4. Your business has a choice of how to cover the cost of paying your participating employee's retirement benefits. Policy cash values can be used through loans and/or withdrawals to make the required payments.[1] Alternatively, your business can pay the benefits from current cash flow and cost recover the benefit payments through the eventual receipt of the death benefit proceeds from the life insurance policy.

5. If your key employee dies before reaching retirement, your business receives the policy's death benefit income tax free and pays survivor benefits to the employee's designated beneficiaries. These payments are deductible by your business and reportable as taxable income to the beneficiaries.

6. Upon your employee's retirement, your business makes retirement income payments according to the terms of the agreement. These payments are taxable income to your retired employee and tax deductible by your business. There are some IRS reporting requirements.



A SERP Case Study

The following hypothetical case study illustrates how a successful construction company used a Supplemental Executive Retirement Plan to help provide long-term financial incentives to one of its most valuable employees, giving him incentives to remain loyal to the company for years to come.

Allerdyce Construction is a successful, privately held construction firm with stable earnings and 30 years in the business. Ben Rolf is the VP of Project Management, overseeing all the company's current construction projects. He is an outstanding performer, and uses his experience to enforce and meet tight timelines that ultimately save Allerdyce a lot of money. Allerdyce currently offers all its employees a 401(k) plan, as well as a legacy defined benefit pension plan. Under the defined benefit plan, Allerdyce pays 65% of the final three years' salary as a retirement benefit. But Ben makes $375,000 a year, and due to government-imposed qualified plan limitations, Allerdyce can only consider $225,000 of his income in the pension benefit calculation formula. Consequently, his pension benefit would be $135,000 at most — only about 35% of his current salary.

To solve this problem, Allerdyce's Guardian representative recommends a Supplemental Executive Retirement Plan to "overlay" the defined benefit retirement plan. The SERP is designed to provide an additional 30% of Ben's final three years' average salary in retirement, to replace the amount lost due to the IRS cap.

A SERP Case Study (continued)

Funding the SERP with life insurance

		Protection Benefit				Retirement Benefits				
Policy Year	End of Year Age	Employer Premium	Employer Net After-Tax Insurance Outlay	Total Plan Costs	Employer Gain/Loss Upon Death	Employer Net After-Tax Insurance Outlay	Executive's Retirement Benefit	Gross Accrued Liability	Net Equity	Effect on Earnings A.L. Basis
1	51	$145,091	$145,091	$145,091	$3,066,287	$145,091	$0	$47,679	$54,574	$-138,196
2	52	$145,091	$145,091	$290,182	$2,924,590	$145,091	$0	$99,173	$191,055	$-60,104
3	53	$145,091	$145,091	$435,273	$2,790,560	$145,091	$0	$154,786	$333,814	$-57,945
4	54	$145,091	$145,091	$580,364	$2,660,433	$145,091	$0	$214,848	$483,115	$-55,852
5	55	$145,091	$145,091	$725,455	$2,534,055	$145,091	$0	$279,715	$639,254	$-53,820
10	60	$145,091	$145,091	$1,450,910	$2,085,523	$145,091	$0	$690,708	$1,605,006	$-23,500
15	65	$0	$0	$1,450,910	$2,350,704	$0	$0	$1,294,592	$1,969,940	$-61,711
16	66	$0	$-110,634	$2,999,786	$639,536	$-110,634	$140,043	$1,246,913	$1,935,919	$13,659
20	70	$0	$-110,634	$2,557,250	$556,776	$-110,634	$140,043	$1,014,877	$1,779,309	$21,495
25	75	$0	$-110,634	$2,004,080	$618,263	$-110,634	$140,043	$603,884	$1,519,579	$36,193
30	80	$0	$-110,634	$1,450,910	$582,170	$-110,634	$140,043	$0	$1,159,370	$58,391
35	85	$0	$0	$1,450,910	$553,581	$0	$0	$0	$1,294,694	$25,303

The example shown here is based on a hypothetical policy not available for sale, using Guardian's Ten-Pay Whole Life policy, 2018 dividend scale, preferred risk class, and averaging male and female values for issue age 50. Dividends are not guaranteed. They are declared annually by Guardian's Board of Directors. A full illustration, showing both guaranteed* and non-guaranteed values, must be provided by a Guardian Financial Representative to an individual applying for a Guardian whole life insurance policy.

* All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims-paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

At retirement, Ben's final three-year salary average is projected to be $400,000. As shown in the above table, Ben will receive a retirement benefit of about $140,000 from the SERP for 15 years. When added to the projected pension benefit, his total retirement income is estimated to be $275,000 and the reverse discrimination problem is solved.

Special Considerations

The advantages of funding SERPs with life insurance

Businesses that wish to informally fund their Supplemental Executive Retirement Plans have a number of investment options from which to choose. However, because most of these investments generate taxable income each year, many business owners look to permanent life insurance as a funding option. That's because it does not have the same "tax drag," as the policy cash value grows tax-deferred, so there is no need for business owners to be concerned about paying taxes on the build-up of the policy's cash value.

Your business can purchase life insurance on the life of any participating employee to "informally" fund the plan's future payments by using the policy's cash value and to recover all of the plan costs at the employee's death with the policy's death benefit proceeds. A SERP informally funded with the proper amount of life insurance provides flexibility, while helping your business pay promised benefits and ultimately recover the cost of establishing the plan. It's a cost-efficient way to provide a valuable executive benefit program.

The advantages SERPs offer employers and their key employees

Advantages for your business:

- **Flexibility:** Your company can select the key employees who will participate — and can offer different participants different benefit levels.
- **You can customize the benefit:** Your business can tailor the plan to meet your executives' needs, and vary benefits and timing based on what is most appealing to each participating executive.
- **Financial benefits:** The life insurance policy grows tax-deferred and is listed as an asset in your corporation's books. The death proceeds can be used to help recover plan costs.
- **Tax advantages:** Your business gets a tax deduction when it ultimately pays the benefit.

Advantages for your key employees:

- **Their retirement benefits are supplemented:** Your participating employee will receive an additional retirement benefit to make up for benefits they lost out on due to reverse discrimination.
- **Tax advantages:** No income tax is payable by the employee on the benefit until it is actually paid out.

When a SERP is not ideal

SERPs aren't ideal for all businesses. Your business should consider the possible disadvantages of this type of plan before implementing it. These include:

- SERPs are a liability that must be reflected on the sponsoring company's balance sheet.
- Employers that choose not to informally fund their SERPs must use cash flow, or borrow, to meet the obligations of the plan when they come due.

Tax considerations

It's always advisable to consult your tax advisor for guidance. Some general guidelines, however, that you may wish to keep in mind with respect to how insurance obtained to fund a SERP can affect the taxes of your business are these:

- Life insurance premiums are not deductible by your business.[2]
- Insurance proceeds are received income tax free by your business.[3]
- In pass-through entities such as S corporations, LLCs and partnerships, the death benefit proceeds increase the basis of the company's business interest. Premium payments, policy cash values and policy dividends may also impact your company's cost basis.

Protecting the Income Tax Exclusion for the Death Benefit

In order to protect the income tax exclusion for the death benefit, there are four general requirements:

1. Notice must be given to the insured, and her or his consent given for the coverage obtained;
2. Either the insured must fit into certain categories, or the proceeds must be used for certain purposes;
3. There must be record-keeping; and
4. Reporting to the IRS concerning these policies must be completed using IRS Form 8925.

Compliance with IRS Section 409A

Your SERP must comply with Section 409A of the Internal Revenue Code. If it does not, plan participants could be subject to immediate income taxation, plus interest and a 20% excise tax on the plan-related income that the IRS deems to be taxable.

Keeping the plan exempt from ERISA

- In order to ensure that your plan does not fall under the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), you should make sure that your SERP qualifies for the so-called "top hat" plan exemption. Under this exemption, any plan that is "maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" is exempt from the participation, vesting, funding and fiduciary responsibility rules of ERISA, but instead, is subject to the limited reporting and disclosure requirements of ERISA.

You should consult with your legal and tax advisors to ensure that your business has addressed all of these special considerations before implementing a Supplemental Executive Retirement Plan.

Could A SERP Help Your Business — and Your Key Employees?

Only you and any other decision-makers in your business can answer that question. But since the strategy discussed in this guide can be complex, you should consider seeking the advice of your tax and legal advisors to help ensure that your business is making the right employee benefit choice — one that helps to satisfy the long-term needs of your business and your participating employees.

A Guardian Financial Professional can work with your trusted legal and tax advisors to help you design the kind of SERP that could work best for your company.

Contact a Guardian Financial Professional to learn more about this valuable executive benefit strategy today.

Every day, Guardian makes the lives of 26 million Americans more secure through our insurance and wealth management products and services. From our founding in 1860, when 21 immigrants joined together to insure and protect their businesses and families when others wouldn't provide them with insurance, doing the right thing for our policyholders and customers has guided everything we do.

Today, as a Fortune 250 company we are one of the largest mutual insurance companies in the country. We've had the privilege of helping a lot of people and remain one of the most highly rated in client satisfaction and financial strength, having paid competitive dividends to our policyholders every single year since 1868.

Values run deep at Guardian and are based on our founders' ideals of doing the right thing, holding ourselves to high standards and knowing people count. That strength drives our ability to perpetuate success through service and innovation, so we continue to give people the security they deserve for life.

[1] Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under age 59½, any taxable withdrawal may also be subject to a 10% tax penalty.

[2] Guardian, its subsidiaries, agents, and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.

[3] Employer-owned life insurance is received income tax free by the business only if IRC 101(j) is complied with.

All scenarios and names mentioned herein are purely fictional and have been created solely for training purposes. Any resemblance to existing situations, persons or fictional characters is coincidental. The information presented should not be used as the basis for any specific investment advice.

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