

# Due Diligence & Best Practices for SERPs

## OM EXECUTIVE BENEFIT CONSULTANTS



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# OM Financial Group

Specialists in Credit Union & Nonprofit Executive Compensation

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- Founded in 1999
- Originated Split Dollar Plans for credit unions
  - OM received first industry approval from NCUA in 2005
  - Provide guidance to NCUA on Split Dollar Plans
  - Over 400 credit union clients nationwide and successfully completed over 1,000 NCUA Audits
- Regional Benefit Consultants around the country
- Full administrative staff, including actuaries and attorneys



OM Financial Group

# Our Mission

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*“To equip credit unions and nonprofits to make fully informed decisions when considering executive reward and retention programs”*



# Nonprofit Compensation Philosophy

Rewarding & Retaining Key Executives

- Deferred Compensation Plans
  - Reward
  - Retention (Golden Handcuffs)
  - Fairness
    - Restoration Plan

# Filling the Retirement Income Gap

## Supplemental Executive Retirement Plan (SERP)

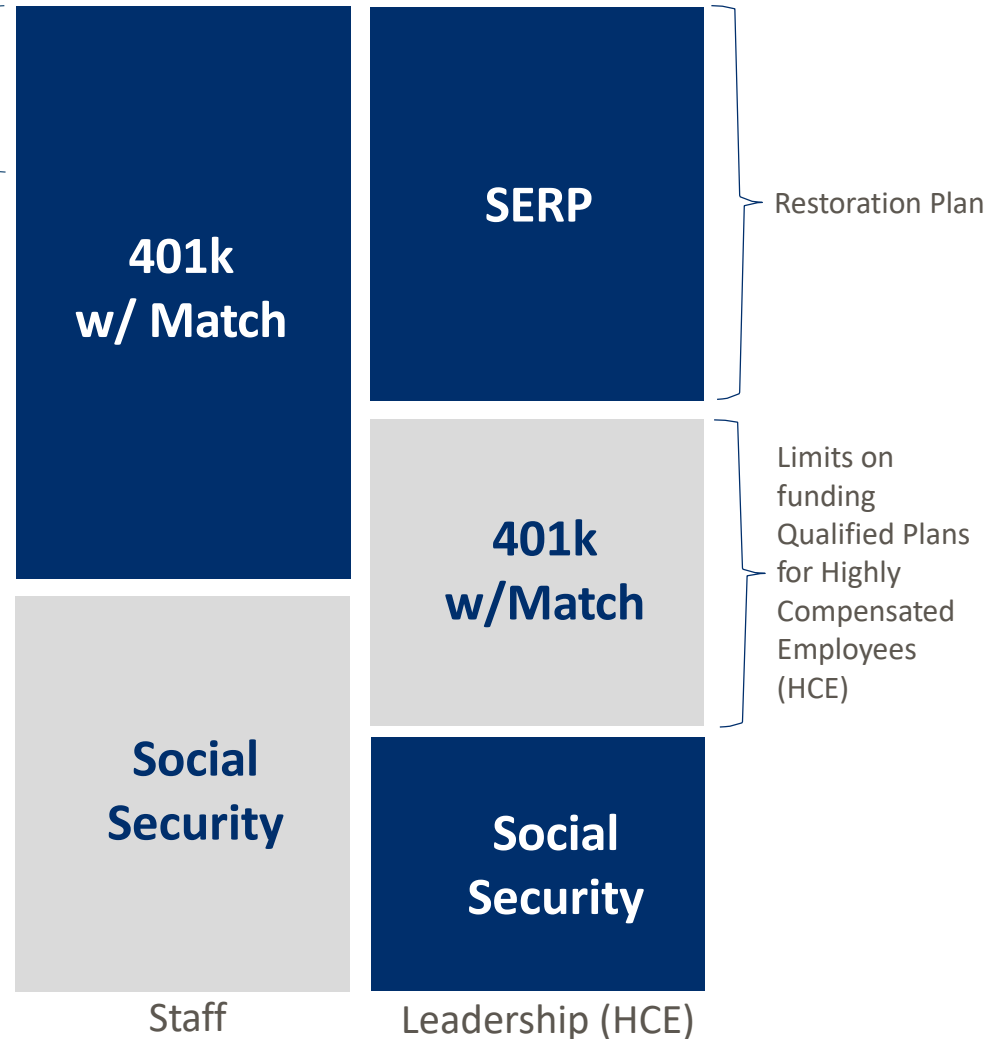
60% - 85% Income <sup>1, 2</sup>  
Replacement Ratio Target

“Typically people need between **65% and 75%** of their pre-retirement income to maintain their lifestyle once they stop working.”

*The House and Living Standards in Retirement* Alicia H. Munnell and Maurice Soto Center for Retirement Research At Boston College December 2005, No. 39

“Common financial planning advice suggests target replacement rates should be between **65% to 90%** of preretirement income. We find a median optimal target replacement rate of 0.75 for married couples (and 0.55 for singles).”

*What Replacement Rates Should Households Use?*  
John Karl Scholz and Ananth Seshadri  
Michigan Retirement Research Center University of Michigan September 2009



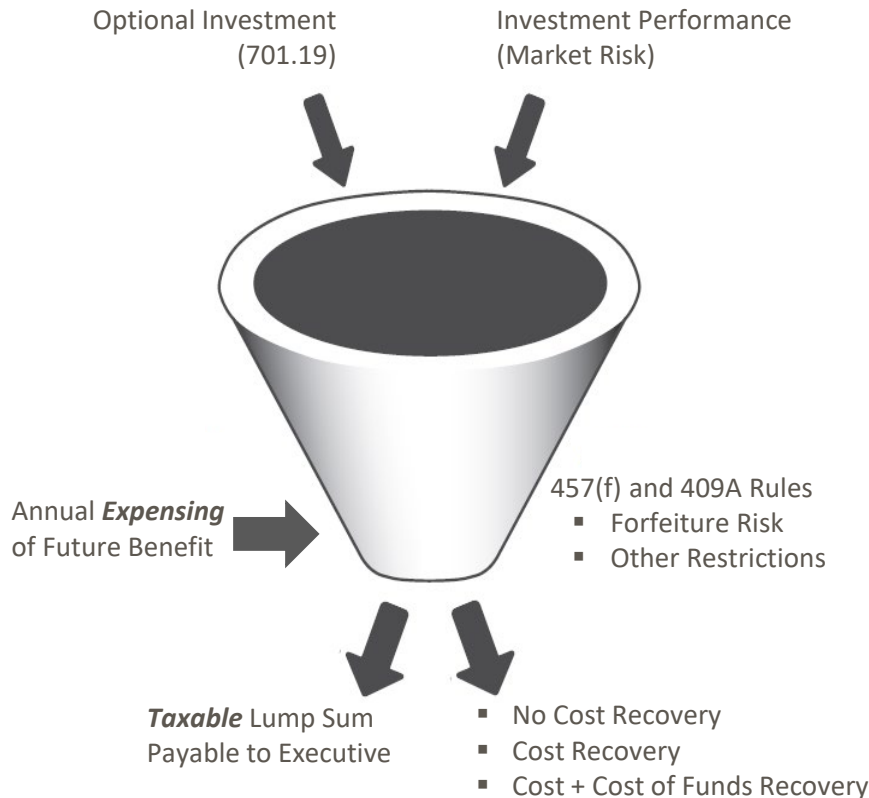
Staff

Leadership (HCE)

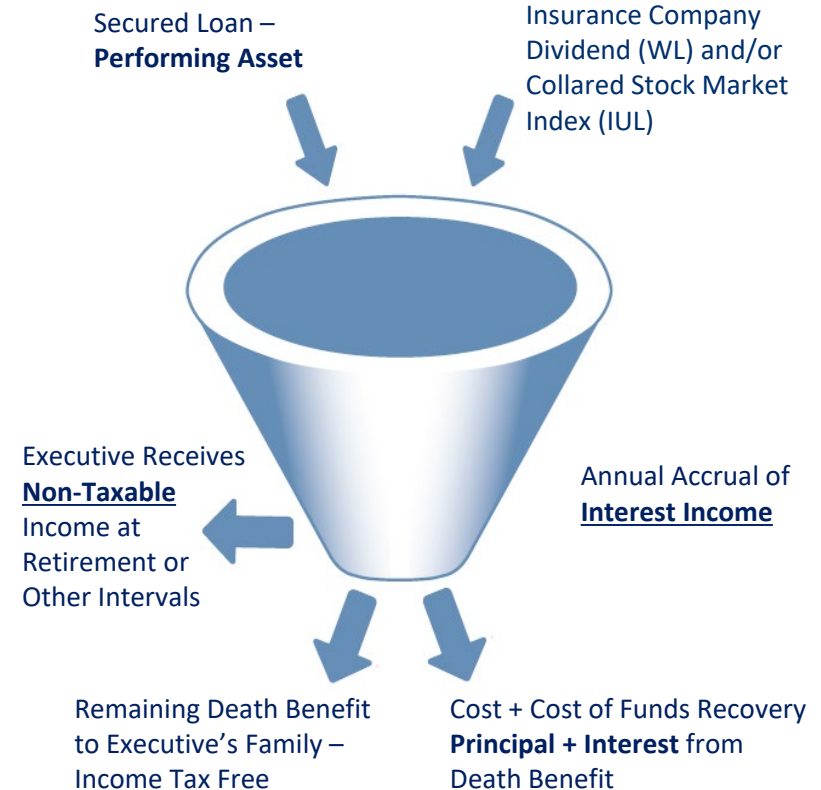
# Supplemental Executive Retirement Plan Options

457 (f) vs. Collateral Assignment Split Dollar (Split Dollar)

## 457 (f)



## Split Dollar



**Note 2018 Tax Law:** When total compensation exceeds \$1 million (i.e. salary + bonus + 457f payout), there is a 21% excise tax on the amount in excess of \$1 million, payable by the Credit Union.

# Collateral Assignment Split Dollar Plans

## Funding

### Mortgage



### Split Dollar



# Collateral Assignment Split Dollar Plans

## Distributions

### Home Equity Line of Credit (HELOC)



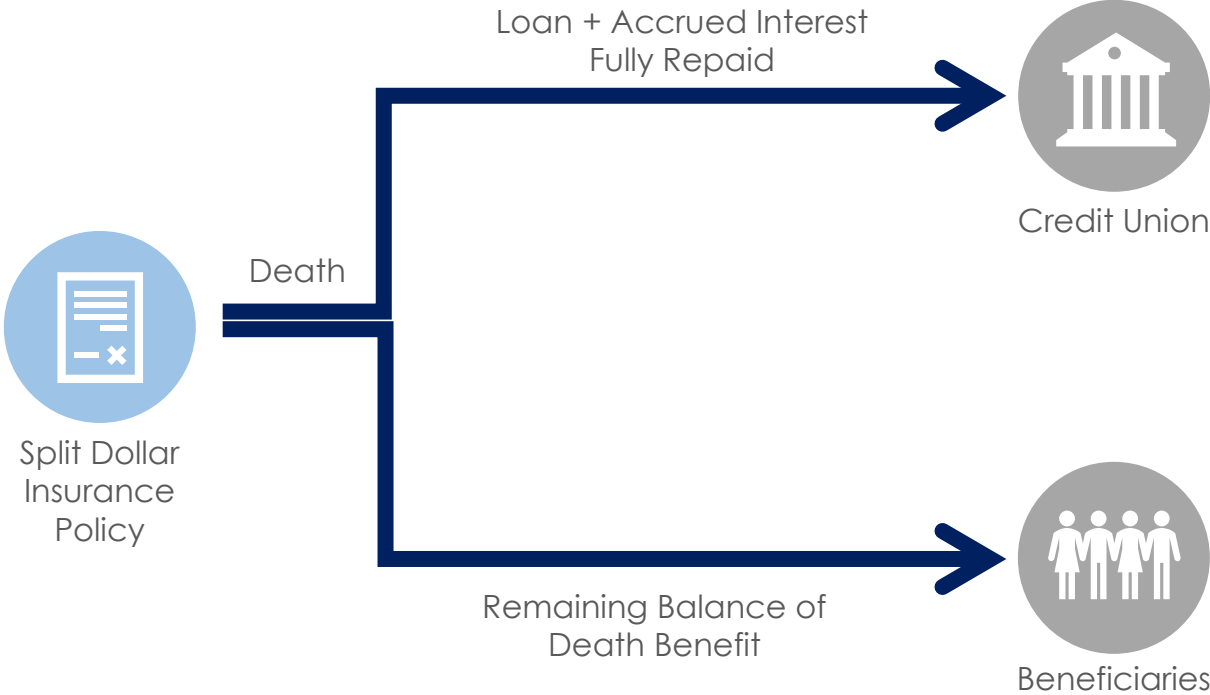
### Split Dollar





# Collateral Assignment Split Dollar Plans

## Payback



# 457(f) Plans

- Funding policy owned by the credit union with a promised future benefit
- Regulated by and restrict flexible design and future program changes
- Risk of forfeiture is required to avoid taxation; when vesting occurs taxes must be paid
- Benefit subject to creditors of credit unions
- Funding the program generally creates financial liabilities that must be booked as expenses because of a promised future benefit
- Payout is taxed like any other W2 income; possible excise tax to the credit union

# 457(f) Plans, Continued

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- Few estate planning opportunities because of risk of forfeiture and lump sum taxation.
- NCUA Rule §750 puts future benefit at risk if credit union is impaired.
- Have a definitive term; credit union obligation ends when paid out
- Best for specific time vs career
- No capacity limits
- No health or age limitations

# Split Dollar Plans

- Affordable - with positive impact on credit union financial metrics
- Exceptional retirement planning opportunity
- Provides for an outstanding permissible investment opportunity
- Provides a competitive edge for attracting, retaining and rewarding key employees
- Provides tax-free death benefit to beneficiaries and estate, providing effective estate planning
- Tax advantaged
- Generates substantial tax preferred retirement income, with control of distributions

# Split Dollar Plans, Continued

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- Premiums paid by credit union
- Premiums repaid by the policy
- Executive owns policy (cash values not subject to personal creditors)
- Funding policy owned by the executive with the credit union responsible for funding costs
- Regulated by IRS and provides complete flexibility in plan design and future changes
- No risk of forfeiture required, thus vesting can occur without triggering taxation

# Split Dollar Plans, Continued

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- Benefit NOT subject to creditors of credit unions
- Funding the program produces no expenses for the credit union
- Loans are a performing asset of the credit union (accrue interest)
- Taxation based annually on imputed interest; we design policy to pay this
- Complete distribution flexibility decided by the executive
- Specifically exempted from NCUA Rule §750 (Permissible Golden Parachute Payments)

# Board Considerations/Due Diligence

## Service Provider

- Industry history and knowledge
- Due diligence provided
- Plan servicing/continuity
- Ongoing educational support
- NCUA and state regulator monitoring
- Adherence to industry best practices



# Board Considerations/Due Diligence

## Plan Choice & Design

- Goals and intent
- Analyze executive needs & credit union financials
- Benefit provided
  - Income replacement ratio vs. targeted dollar
  - Term of benefit
  - Interim payouts during accumulation
  - Coordination with employment agreements
  - Vesting schedule
- Downside risk protection built into the plan





# Board Considerations/Due Diligence

## Plan Choice & Design

- **457(f) Considerations**

- Income replacement ratio vs. targeted dollar
- Defined benefit vs defined contribution
- Cost recovery vs no cost recovery
- Investment vehicle
- Assumed rate of return

- **Split Dollar Considerations**

- Whole Life vs. Indexed Universal Life (IUL); one policy or two policy design
- Rating of insurance company
- Interest rate

# Board Considerations/Due Diligence

## Plan Implementation

- SERP Policy
- Due Diligence – as discussed in other slides
- Executive education and planning
- Underwriting
- Board resolution
- Funding
- Documentation



# Board Considerations/Due Diligence

## Plan Administration

- Servicing
  - Exam, audit, accounting, legal and tax support
- Annual reviews
- Retirement withdrawals
- Plan changes & amendments
- Employment separations
- Regulatory updates
- Weekly educational webinars



# Types of Collateral Assignments

**Non-recourse:** Rely solely on underlying insurance policy for repayment

- Neither the employee nor employee's estate is responsible for shortfall
- Shortfall could be taxable to employee as forgiveness of debt income

**Limited recourse:** Primarily rely on underlying insurance policy for repayment

- Employee and/or estate could be called upon to make up deficiency
- Employer seeks payment from life insurance company first

**Full recourse:** Similar to limited but employer seeks payment from employee; employee has burden to pursue recovery with carrier



# Legal Basis for Split Dollar Plans

- IRS code establishes Loan Regime Split Dollar as an acceptable form of deferred comp with specific taxation requirements
- NCUA sees the value as a part of comprehensive strategy to recruit, incent, retain and reward talent
- NCUA views loan regime as a benefit; loans are exempt from limitations in “loans to members” or “loans to officials”
- NCUA sets **guideline** for split dollar loans at ~25% of net worth
- NCUA permits recovery of cost of funds but prohibits recovery of opportunity cost
- Most states have a parity rule for these items; some have specific rules



# Accounting of Legal Agreements (SD)

- Structured specifically where the credit union can book full face value of the note
- Book annual income against an accrued asset
- Guaranteed return of premium and interest; no net cost to credit union
- Executive can draw tax free retirement income
- Imputed interest/tax implication for a below market rate loan
- Follow GAAP & FASB guidelines



# Compliance Factors for Split Dollar Plans

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- Protect the interest of the credit union at all times
- Meaningful & appropriate benefit for executive
- Minimal legal, accounting or compliance risk when properly constructed and in force

# Our Promise

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- Complimentary SERP analysis of any plan, any provider
- Complimentary stress testing
- Weekly educational webinars



# Thank You!

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**Connect with me on LinkedIn!**