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The Latest on Executive Retirement Benefits

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Summary: Panelists discuss programs that provide retirement benefits for executives in the United States and Canada, including the pros and cons of available financing vehicles and the impact of governmental requirements and proposals.

Questions addressed include:
- *Who qualifies for these benefits?*
- *What benefits are provided and how are they determined?*
- *To what extent are payments guaranteed by external parties?*
- *Are significant current trends emerging?*
- *How is the regulatory environment changing?*

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MR. DOUGLAS FREDERICK: My name is Doug Frederick. I work with Mercer. I'm a fellow of the Society of Actuaries, and I work out of Mercer's Louisville office. I've been with Mercer for 10 years, and I am part of Mercer's Executive Benefits Practice. We are a national resource group located in Louisville that supports all of Mercer's 40+ offices in the United States when it comes to the consulting of executive retirement and other benefits, such as life insurance.

MR. SCOTT CLAUSEN: My name is Scott Clausen and I am a fellow of the Society of Actuaries and a fellow of the Canadian Institute of Actuaries. I have been in the Retirement Practice in Mercer's Toronto office for 12 years, currently specializing in executive retirement benefits. Doug and I are going to spend about 10 to 15 minutes on an introduction, some terminology and some general discussion about qualified plans and non-qualified plans in the United States and Canada. We will then spend about 15 to 20 minutes on each of three separate areas with respect to eligibility and level of benefits, trends that are developing and methods of providing benefit security. We will then close with a discussion of where things are heading with respect to regulatory changes and trends in each country.

One common trait we find in dealing with executives is that they have the same concerns about their retirement as other employees, but they often spend even less time thinking about their retirement plans. Executives ask the same questions, such as how much do they need to retire, how soon can they retire and what pension will they receive from the company. These are the standard questions you get from most employees.

However, unlike most employees, executives also have unique challenges and opportunities. Specifically, their ability to receive pension benefits from qualified or registered programs is substantially limited. The higher up you move in the organization, the less you are going to see coming out of these qualified plans.

In many cases, senior executives also have the unique ability to negotiate enhanced benefits that other employees do not receive, such as trading one compensation for another, or just simply negotiating a few enhancements. One developing area that we see—one that we are going to spend time on when we discuss recent trends—is an increase in the level of shareholder activism, media attention and governance surrounding executive pension benefits. For example, if senior executives are going to be the primary beneficiaries of such programs, who should be designing these programs and who should be taking ultimate responsibility for determining what benefit levels are appropriate? Historically, it was often the same executives who were going to be entitled to the benefits that did the majority of the design work. We see a shift in responsibility going forward. In the United States, which Doug will talk about, there has been a trend toward regulatory movement with respect to deferred compensation plans.

The overall benefit levels provided are very similar in Canada and the United States. However, the terminology is quite different. Specifically, you will hear Doug referring to "qualified" plans and "non-qualified" plans, whereas I will refer to "registered" and "non-registered" plans. The primary difference you will find in Canada versus the United States is that in the United States, there is a more defined split between supplemental executive retirement plans (SERPs), which provide enhanced benefits to designated executives, and IRS tax restoration plans, which essentially mirror the registered plan and provide benefits above the tax limits for all employees. In Canada we refer to both plans as SERPs. For this presentation, I will try to use the term "restoration" when dealing with some of the Canadian topics.

MR. FREDERICK: Before I begin, one thing I would like to add to the material Scott just covered is that in the United States the term "deferred compensation" tends to be used very loosely. It can be used to describe an employer-provided benefit that simply restores limits in the qualified plan, or maybe it provides benefits over and above the qualified plan, such as the SERP, but it can also be used interchangeably to describe employee-only monies that have been deferred through a voluntary deferred compensation program. The majority of our presentation is going to focus on the employer-provided benefits that most people put in the SERP or restoration plan bucket, but the term "deferred compensation" can interchangeably be used to talk about all of them.

Before we talk about non-qualified plans or SERPs, we both thought it would be best to give some background on how qualified or registered plans work. Both within the United States and Canada these programs are afforded very favorable treatment. From the employee’s perspective, vested benefits are secure because employers are required to earmark or set aside assets in a qualified pension trust. From a taxation point of view, the individual’s benefit can be secured, yet taxation is delayed until the individual reaches retirement and actually receives the benefit. Furthermore, the pension regulations in both countries are aimed at protecting the participant.

From the employer’s point of view, these plans can be attractive as well. Funding contributions to qualified programs are deductible when made and, in addition, investment earnings within qualified pension trusts are tax-free. In return for this wonderful treatment to both employers and employees, these plans are subject to strict regulatory requirements. Within the United States we’re subject to limits on benefits and discrimination testing. In Canada, they’re subject to the benefit limits as well, but there is no discrimination testing. Furthermore, in both countries you are required to perform valuations for purposes of funding and accounting.

Limits exist in both the United States and Canada. On the U.S. side, these limits can come in many forms. There is a compensation limit that restricts the compensation that can be used in the formula in determining a pension. There is a secondary limit, or benefit limit, that says on the back end there’s a restriction on

the benefit level that can be paid from these programs. Lastly, in 401(k)-type programs, there is an elective deferral limit that restricts the amount that an individual can contribute on a pre-tax basis to these programs. The compensation limit applies to both employer-provided pension plans and elective deferrals to a 401(k)-type program. The limit is currently $200,000, and it is indexed with inflation.

After applying the compensation limit, a second limit, or gateway, that's applied is the 415 dollar limit. In simple terms, within an employer-provided defined benefit (DB) pension, an individual age 62 or above could receive up to $160,000 payable per year for life. That limit is further reduced if benefits commence before age 62 and/or if service is below 10 years. Lastly, the elective deferral limit applies to 401(k)-type programs. That limit is currently $12,000. In 2004 it will be $13,000, in the following year it will be $14,000, and so on. One key point I would like to make about the limits on qualified programs is that, for the most part, one limit does not offset the other. In theory an individual could have an earned or accrued DB pension of $160,000 per year in the United States and, in addition, that same individual would be eligible to defer $12,000 to their qualified 401(k). As Scott will tell you, that's a little different than in Canada.

MR. CLAUSEN: Registered pension plan limits is an area where Canada and the United States differ. In Canada, there is a benefit limit for defined benefit plans and a contribution limit for defined contribution plans. However, there is no pre-set earnings cap. Defined benefit plans have a dollar limit on the amount of pension that can be paid per year of service with an employer. In 2003, the limit is the lesser of $1,722 per year of service or 2 percent of average indexed compensation per year of service. For an executive, this essentially means a limit of $1,722 per year of service. The level of earnings at which the limit is reached will depend upon the benefit formula provided by the pension plan. For a 2 percent pension plan, the limit is reached at earnings of approximately $86,000 Canadian.

On the defined contribution side, there is a limit on the dollar amount of contribution. In 2003, the contribution limit was the lesser of 18 percent of income or $15,500 Canadian, which includes both employee and employer contributions.

Canada also has a vehicle that is similar to the 401(k) in the United States. This vehicle, called a Registered Retirement Savings Plan (RRSP), is funded by employee contributions that are tax deductible. The investment returns accrue on a tax-deferred basis. The difference in Canada is that, for an individual who is entitled to registered pension benefits from either a defined benefit plan or a defined contribution plan, the value of those benefits are applied to reduce RRSP contribution room. Thus, you will find that executives receive almost no RRSP room to personally save for retirement on a tax-deferred basis.

The defined benefit limit of $1,722 has essentially been in place since 1976. There were announcements in the 2003 federal budget that the limit will increase to

$1,833 in 2004, to $2,000 in 2005 and be indexed thereafter. There have been announcements in prior budgets about increases, which have been frozen and delayed. However, it appears at this time that the pension limits will actually increase in 2004 (albeit marginally) from the 1976 level.

MR. FREDERICK: I'd like to add one point about the United States and how the limits have moved. I've been doing this for just over 10 years, and I've already lived through three different sets of limits. The general rule of thumb is that when we have a Democrat in the White House, the limits go down; when we have a Republican, the limits go up. What will happen with the pension limits depends upon the election results in 2004.

For the typical executive, age 65, the maximum income replacement that could be expected from a qualified plan in the United States versus a registered plan within Canada is, not surprisingly, considerably higher within the United States The reason is predominantly due to the fact that the Canadian limit hits at a very low pay level—$85,000 to $90,000 in Canadian terms, which is equivalent to roughly $55,000 to $60,000 on the U.S. side. One caveat is that when you get to the top executive level, say the CEO or CFO in both the United States and Canada, the level of retirement benefits from the qualified plan is minimal—it's less than 10 percent. In other words, 90 percent of the retirement benefits are coming from these supplemental programs. From the executive's point of view, the supplemental programs are the material part of his or her retirement package. That's why there is so much focus from their point of view and why there has been so much focus from the media and the boards as well.

Now that we have a good grounding on qualified programs, let's jump into non-qualified or non-registered programs. In the United States, these programs are not given the same favorable tax treatment that the IRS gives qualified programs. From the participant's point of view, the majority of these plans are unfunded, unsecured promises to pay benefits. To the extent benefits are formally funded or secured, the individual is currently taxed now rather than when benefits are received. From a company's point of view, should they choose to earmark assets on an informal basis, the contributions for those assets are not deductible when made. Typically benefits are only deductible as paid to the individual. In the United States, the timing of taxation to the individual and the timing of the deduction to the employer happen or occur at the same time. That's a key point, because later Scott will talk about how it's a little different in Canada. Furthermore, for any assets that are earmarked by the employer, the investment earnings on those assets are taxable to the employer unless they're sheltered, for example, within corporate-owned life insurance (COLI).

But in return, these programs are not subject to strict regulatory requirements like their qualified counterparts. From an ERISA compliance point of view, compliance is minimal, typically just a one-page Department of Labor notification. From an annual valuation point of view, you do not need to fund these plans, so funding valuations

are not required, but you still are required to account for these plans. They still are legitimate obligations, and they should be carried on the company's balance sheet and affect the income statement. Lastly, you're not subject to any discrimination testing. You can pick and choose who is eligible for these programs and what level of benefits to offer. Historically we have not seen a limit on the level of these benefits. Typically it has been subject to competitive practice and/or board approval. However, recently we have seen a lot of scrutiny around these benefits, and I firmly believe that enhanced checks and balances will be put in place in the near future.

MR. CLAUSEN: The structure of regulation and taxation for non-registered plans in Canada is very similar to that in the United States. The most significant difference is that in Canada, it is possible to secure a supplemental or a non-registered retirement arrangement from creditors without causing an immediate tax liability to an executive. I will describe the methods in more detail later in the presentation, but this ability is one of the significant differences.

As in the United States, non-registered plans are exempt from provincial or federal pension legislation as long as the employer is providing a registered pension plan that provides the maximum benefits. In other words, supplemental plans are only exempt if they are topping up a maximum benefit. There are some exceptions, but in practice, almost all employers automatically provide as much as possible out of a registered plan in order to provide the most tax-effective benefit and to have the lowest cost to the employer.

Now that we have gone through a quick introduction of qualified and non-qualified plans, Doug and I are going to move through each of the next three sections, talking about what we see in each in Canada and in the United States. Because of time constraints, we have left out many other areas that could be discussed , but the goal is to give a general overall magnitude of the levels of benefits provided.

Our presentation includes many references to survey statistics. The sources of the statistics are from proxy analysis and published surveys in the United States and from a database that Mercer maintains in Canada on the practices of its Canadian clients. The database in Canada includes information on approximately 300 SERPs.

On the question of what level of employee is typically entitled to receive supplemental executive benefits in Canada and the United States, the answer is that these benefits tend to be restricted to senior executives. This restricted eligibility also applies to many restoration-type plans in Canada. Having a restoration SERP that simply lifts the tax limits does not automatically mean that every employee who is affected by those limits is entitled to a benefit. In the United States, the vast majority of restoration plans tend to provide benefits to all affected employees, whereas in Canada it's closer to about one-half of all affected employees. One of the reasons for the difference is the level at which the tax limits apply. In the United States, if you are affected by the earnings cap under a

qualified pension plan, you will almost always be a senior executive and will be entitled to executive benefits. In Canada, where the limits are much lower, it is common to see many high-income employees who are not entitled to supplemental executive benefits but who are affected by the pension limits. It is a much bigger decision for a company to say it will give SERP benefits to every employee affected, when "every employee affected" could be one-quarter of its employees.

MR. FREDERICK: Now that we've given you an overview of how these plans work and who is eligible, the burning question is: How much do they get? My comments would probably be indicative of a Fortune 100 or Fortune 500 type executive.

For a long-service or full-career executive, with say 20 to 30 years of service, you could expect income replacement to range somewhere between 40 percent and 60 percent of final average earnings. Final average earnings are typically based upon base salary and annual short-term incentive. The sources of benefits that typically comprise this level of income replacement are the non-qualified plan, the qualified plan, Social Security and sometimes even the 401(k) employer match is included. Rarely, though, do we see quoted in these surveys employees' own contributions to a 401(k)-type program. The earliest age we typically see these benefits paid on an unreduced basis is age 62 to age 65. Through certain key executives' employment agreements, you may see that unreduced age begin to creep down. For the most part, the normal or free form of these benefits is a single life annuity.

To give you an idea of the magnitude, for a long-service CEO who may be within a Fortune 500 company, it's very easy for the lump sum value of the SERP to get upward of $10 million. This is what has grabbed the media's attention and has been making headlines as of late. In certain instances, if you take that same SERP that might be market-competitive and produce a $10 million lump sum value, all it takes are a few small tweaks and changes to that SERP program through the CEO's employment contract to produce a much larger number. Some examples include notional service to pick up what the CEO forfeited from a prior employer, the inclusion of extraordinary bonuses or long-term incentives, allowing an unreduced benefit, say at age 60 or below, or even the use of a subsidized interest rate when paying a lump sum. Suddenly the $10 million goes to between $50 million and $60 million. You can take a plan where the overall guts of it and design is market-competitive, but a few small changes that don't even exist in the plan document can increase the benefits five- or six-fold.

One thing that I fully expect to see change in the United States, and which has already started getting momentum, is to not just look at competitiveness of SERP benefits on an income replacement basis, but to ask for the lump sum value of that benefit. That's the item that tends to hit the press and to give people sticker shock, so I expect boards in doing their annual reviews to not only focus on the level of income replacement, but also on the potential lump sum value that might be paid when that executive retires.

MR. CLAUSEN: In the area of benefit levels, there are similar practices in both Canada and the United States. One difference is that when we look at the competitiveness and survey results, we tend to focus less on replacement ratios and more on benefit accrual rates. Typically an executive plan provides a benefit of about 2 percent of final average salary or final average earnings per year of service. Essentially that means 40 percent after 20 years, or 60 percent after 30 years, which are very similar to the numbers Doug was discussing. In addition, when hiring certain key executives, it's not unusual to see enhanced accrual rates or extra service credits as part of the hiring of those executives, especially if they are hired late in their career. These enhanced late-career hire benefits tend to not find their way into survey statistics, as they are provided based on individual circumstances.

The benefits, as in the United States, are often integrated with both government benefits and registered plan benefits. A typical executive plan could be described as a 2 percent accrual rate inclusive of benefits under a qualified or registered plan, as well as inclusive of benefits under government programs such as the Canada Pension Plan or Quebec Pension Plan.

With respect to ancillary benefits, it is common in Canada to provide unreduced early retirement anywhere from age 60 to 65 under the general terms of a SERP, whereas in the United States, unreduced early retirement tends to be more of a special deal. In addition, most SERPs provide automatic survivor benefits, often with some restriction that there is only a certain number of years of age difference between the executive and his or her spouse.

One item that impacts the design is that three-quarters of all supplemental plans simply mirror the benefit rate under the registered pension plan. This "mirroring" concept applies to about two-thirds of SERPs that only provide benefits to designated executives. It is common to say that if you earn two or three times as much, you get two or three times as much pension. Many companies try to keep the benefit design as uniform as possible among different levels of executives.

As Doug previously mentioned about the United States, one of the biggest trends in Canada is around governance. Who should be entitled to design these SERPs? Who should be making the decisions? For example, does the registered plan include bonus in pensionable earnings? This is a topic we will discuss shortly. With these significant cost issues, it would be unusual for an executive to voluntarily say, "I do not want change in the SERP that will increase my benefit." Boards are starting to pay a lot more attention to the design of SERPs and deciding how, when and who should be granted these benefits.

There is a very small percentage of companies that automatically provide a benefit accrual rate of more than a 2 percent rate, and there is a fair number that provide less than 2 percent. A 2 percent accrual rate is a typical executive benefit level.

With respect to early retirement ages, many of the formal plan documents in the United States tend to key in on retirement at age 65 with reduced pensions before age 65. In Canada, it is common for the regular plan provisions to provide unreduced retirement as early as age 60. In the United States, you tend to find that the unreduced age is negotiated down as a "special deal" for key executives.

The earnings definition is a common topic of discussion among many clients. In Canada, the practice of bonus inclusion is evenly split, with about half of companies including bonus in their definition of pensionable earnings and about half the companies including only base salary. The inclusion of bonus is one decision for a company to make where bonuses are always within a fairly narrow range, such as 30 percent to 40 percent of salary. For other companies, where bonuses range from 0 percent to 300 percent of salary, a decision on the inclusion of bonus may differ. As pensions are lifetime benefits, they are often paid for 30 or 35 years. There is an issue of whether three or four years of strong corporate performance, and the related bonus payments, should affect pension benefits for 30 or 35 years.

Historically, there has been very little link between annual bonus awards and how these awards affect pensions. We are starting to see and more boards asking about this link. Before a bonus is granted to an executive, the board wants to know what the impact of this bonus is going to be to the pension. There have been circumstances where boards have granted unusually large bonuses to executives near the end of their career as a reward for long service, not realizing that those bonuses would be pensionable under the terms of the pension plans. A bonus award of $2 million or $3 million may result in additional pension liabilities of $10 million to $12 million for a long-service executive. If bonuses are included, there is likely to be more pressure to continually remind boards and the compensation committees of the impact on the pension plan of any changes in compensation.

MR. FREDERICK: One key difference you see on the U.S. side is that the vast majority of our programs include base salary and short-term annual incentives in the earnings definition. Only a handful just include base salary and a smaller percentage include long-term incentives. I can't stress enough Scott's point of being on alert or noticing the red flags for inclusion of extraordinary items in compensation. I can think back to a client I worked on a year ago, where I was asked to review a 20-page employment agreement for a CEO. Somewhere in the middle of that agreement, between the unlimited cell phone use and the company car, was the following sentence: "In addition, the value of stock options will be included in the definition of earnings for purposes of determining the SERP." This was an employment agreement that was worth $20 million to $25 million. That one sentence added $50 million to $75 million to the SERP, so suddenly something magnified from $25 million up to $100 million because of one sentence. This is an area where all involved parties—the board, the compensation committee, the consulting pension actuary or the executive compensation consultant—need to understand the effect on the pension, and this is an area for a lot of exposure if all parties don’t properly talk.

We've talked about what goes into the compensation. Another area is the averaging mechanism. On both sides, in the United States and in Canada, the most prevalent is to use a final average three years or final average five years. One point Scott alluded to is that bonuses could be problematic due to volatility and fluctuations. What I've seen in my experience are two extremes. At one end, bonuses create negative retention, where those individuals receive a few good years, their pensions escalate more than they ever thought and they leave—there's no succession planning. At the other end, if you have a short averaging period, say a final average three, and the individual anticipates getting a very poor bonus that will be with him or her for the next three years, they may suddenly leave. Thus, a poorly designed SERP program can create negative retention on both sides.

The other thing to be careful of in looking at the compensation period is that sometimes the plans are written to be a strict 60- or 36-month average. Due to a glitch in payroll of paying a bonus early, paying a bonus late, or the request of an executive, suddenly you may have six bonuses that were paid in a five-year period where no one intended those to be pensionable. Things like that can be interesting on the compensation side.

The next area we want to move into is benefits security. We've talked about how these benefits have worked. We've talked about how material they are. The next natural progression is the security of these plans. This is an area where there are many options. It's very challenging, and there are some interesting points that are different on the U.S. versus the Canadian side.

First, let's talk about our objectives. Why would someone fund? The obvious reason would be to provide security. These benefits are sizable and material from the executive's point of view, and some companies take the perspective that they should be on equal footing as the qualified plan, and therefore, these benefits should be secured. Second, depending on the type of SERP program, the value of the SERP may fluctuate with the market. The individual might be given investment selection like a 401(k) plan, and employers are worried about the movement of this liability. It moves up and down like a yo-yo, and so does their expense, so they may earmark or set aside assets that will move in tandem to control the volatility or hedge this liability.

One thing we see in the United States that we do not see in Canada is that some companies fund because they legitimately think they can reduce their costs. This is a situation where banks, in particular, may purchase bank-owned life insurance in conjunction with the SERP liability because the insurance is an attractive investment, and the SERP itself gives them a legitimate business reason to purchase this insurance. Defined contribution plans are much more likely to be funded than defined benefit plans for two reasons. One, it's the perception that it's the employee's own money, and, two, employers are worried about market exposure with respect to the liability.

Let's look at the funding options available in both countries. We're not going to exhaustively go through all of these. The starting point is unfunded programs. What you see is what you get here. This is simply the act of doing nothing. Benefits are mere promises to pay the participant, which are essentially unsecured creditors of the company. As benefits become due, the company typically pays them from general assets. From a taxation perspective, the employee is taxed when benefits are received, and the employer takes a deduction as benefits are paid. You might be asking yourself, is this really a funding or security mechanism? In the United States, about one-half of SERP programs are unfunded and in Canada, a slightly higher number, about 60 percent, are unfunded. In many employers' eyes, this is a legitimate funding strategy. It's the default option of doing nothing.

Moving up the ladder in enhanced security, within the United States, the second most prevalent option is the use of a rabbi trust. The way this works is that the employer may choose to set assets aside and say that only those assets are going to be used to pay executive benefits. It protects the participant against the event of change of control or change in heart by senior management. It does not protect the executive in the event of insolvency. From an accounting and taxation point of view, this arrangement in essence works almost identically to an unfunded arrangement because these assets are not formal plan assets in the eyes of FASB. The most common assets we see held in this trust are corporate-owned life insurance, sometimes mutual funds or even company stock. Again, rabbi trusts are the second most prevalent option in the United States, with about 40 percent of arrangements being funded with a rabbi trust.

MR. CLAUSEN: In Canada, the most prevalent funding vehicle used is a Retirement Compensation Arrangement (RCA). The RCA is one step up from the rabbi trust in the United States in the sense that it also provides full benefit security to executives on insolvency and bankruptcy. Effectively, it is a third-party trust that secures benefits, which tends to be viewed as a significant advantage compared to the rabbi trust.

I will briefly discuss how RCAs work, as there is no similar vehicle in the United States. An RCA is an arrangement where one-half of any contribution plus one-half of any investment income that the trust earns minus one-half of any benefit payments the trust pays, has to be sent to the federal government and held in a refundable tax account. One of the best ways to think about an RCA is that it is similar to a registered pension trust, but it has the requirement that one-half of the book value of the assets must be invested in cash. This cash happens to be held by the federal government. The money held by the government is still an asset of the pension plan, but it earns no investment return. If you could earn a return of, say, 7 percent in a registered plan environment, you can earn a return of 3.5percent in an RCA because you are earning 0 percent on one-half your money and 7 percent on the other one-half.

One of the reasons that RCAs are favored is they are straightforward to operate and the assets are secured from creditors. Employer contributions to these arrangements are tax-deductible at the time the contribution is made and there is no taxation to members until members receive their benefits at the time of retirement or termination. One of the reasons for the structure of the refundable tax is that it bridges the gap between when the corporation was granted its tax deduction and when the government receives its tax revenue from the payment of benefits to members. RCAs were established in the mid-1980s to prevent some abuses of a former vehicle that non-profit organizations were using. It was not intended to be punitive to many corporations, although, given recent changes to tax rates and tax environment, it has become that way.

The one caution I will mention when setting up an RCA is that if there are U.S. taxpayers covered by these arrangements, there are potential tax issues. In the United States, if you set assets aside in a trust that is secured from creditors, those assets are taxable immediately for U.S. tax purposes; in Canada they are not. Thus, if you have a U.S. taxpayer being secured through a Canadian trust, you have some issues that need to be looked at.

MR. FREDERICK: We've gone through the spectrum, from a completely unfunded arrangement to a rabbi trust that is secure in some circumstances. The next couple of items I'd like to talk about are alternatives that provide full-benefit security.

The first one is called an employee grantor trust. This is the type of arrangement that would be synonymous with what you've seen in *The Wall Street Journal* that was used by the airline industry, or even the tobacco industry, to fund SERPs. Effectively what you have is a series of individual trusts established where the employee is the owner of the trust and benefits are fully secure, but in return for the fact they're fully secure, they're currently taxable. What the employer does in simple terms is advance part of the benefit now to cover the early taxation and converts the remaining benefit obligation to an after-tax equivalent. The advance for early taxation is not an enhancement to the benefit, but rather changes the timing or incidence of taxation. Effectively what's left in the grantor trust is the after-tax equivalent of these benefits.

These aren't too prevalent in the United States for three reasons: (1) there is a lot of added cost compared to an unfunded arrangement; (2) companies are having a hard time doing this in light of the current funded status of the broad-based programs or where they are reducing retirement/medical benefits, because it is a real public perception issue to tie up this much money at the same time that you're going in opposite directions with your other programs; and (3) these things can be very complex to administer, and the fees to do so can be large.

MR. CLAUSEN: In Canada there is a similar type of trust, called an Employee Profit Sharing Plan (EPSP), that is almost identical to the employee grantor trust from a tax perspective. Contributions are tax deductible to the employer, contributions are

taxable to the members and all investment earnings earned in these trusts are taxable to the members. Because of the complications Doug mentioned, and also because of the availability of the RCA trust vehicle in Canada, which provides security on insolvency, these trusts are rarely used to fund defined benefit SERP arrangements. The one area where we do find them used in Canada is with respect to defined contribution SERPs, because the taxation is being shifted to an individual tax basis, and individuals are taxed at a rate that's lower than the 50 percent rate in the RCA trust. By shifting defined contribution money from an RCA vehicle toward an individual personal tax rate, it ultimately provides a better benefit.

MR. FREDRICK: The other security option that tends to be very comparable between the United States and Canada is the use of annuity contracts. On the U.S. side, we typically refer to them as deferred annuities. For all intents and purposes, this works very similar to the grantor trust I just talked about where the company, typically during an individual's working career, will purchase annuities as benefits are accrued. These annuities are owned by the participant; thus they are currently taxable, and benefits are secure to the extent the annuity carrier is solvent. Because of the incidence of taxation, the company will advance part of the SERP benefit now to cover taxation. That advance is considered in how much of the annuity we buy, and, at the end of the day, the individual should be left with the same after-tax equivalent income as the underlying SERP obligation.

This option, like the grantor trust, is not very prevalent due to the cost, the public perception (which is the main reason) and the complexity of administering these programs. I see them at smaller companies, particularly in the tax-exempt or health-care industry, where they may only have a handful of participants and where the tax rules for the tax-exempts are a little different than for the for-profits. This is where the annuities may make sense.

MR. CLAUSEN: In Canada, the prescribed annuity is the route that is taken with respect to purchasing annuities for non-registered pension plans. The prescribed annuity is essentially an annuity purchased by individuals for themselves, using after-tax dollars. The primary difference between Canada and the United States is that in Canada a prescribed annuity must be an immediate non-indexed annuity. You cannot purchase a deferred annuity or purchase a stream of deferred annuities annually through an executive's career. When this annuity is purchased, there is a calculation done by the insurance company that splits out how much of every future annuity payment is going to be interest and how much of it is going to be deemed a return of principal. This calculation determines the percentage of the annuity that is taxable and the percentage of the annuity that is tax-free for the duration of the annuity.

This annuity purchase is typically structured with the employer determining how much the company would pay its executives if it paid a pension, how much the executives would receive after tax and what size of annuity would have to be purchased to replicate the after-tax pension. This annuity is smaller than the fully

taxable pension since a portion of the annuity is not taxable. The company arranges for an annuity to be purchased by that individual and grosses up the lump sum to compensate for the immediate tax consequences. In the end, the employee walks away with no more and no less than he or she would have received before, but it's payable through an insurance company rather than by an employer.

In practice, prescribed annuities are rarely used. Because of the tax implications, corporations are much more inclined to calculate the value of the pension, hand the lump sum value to the individual and allow the individual to go out and purchase his or her own prescribed annuity if he or she wants a guaranteed benefit. It tends to be only companies that want to ensure the assets are used for an annuity that require the use of prescribed annuities.

MR. FREDERICK: The last area I'd like to focus on on the U.S. side is the use of a letter of credit. In my 10 years, I've seen a letter of credit used in an effective way probably fewer than five times. In the United States, I rarely see it used as the primary source of security. It might be a secondary what-if-everything-else-fails approach. The problem that creeps in with the letter of credit in the United States boils down to a tax issue. The company goes to a bank and seeks a letter of credit to pay SERP benefits if the company doesn't honor its promise or goes bankrupt. The actual purchase of that letter of credit in many instances will trigger taxation to the individual currently, which will make the act of trying to secure this just in case of a future event to be self-defeating. But as Scott will allude to, there are many more interesting options available for letters of credit in Canada.

MR. CLAUSEN: Letters of credit are prevalent in Canada for securing supplemental pension benefits. The reason is, as with the funded RCA, the letter of credit can provide benefit security to an individual without triggering immediate taxation to that individual. As I mentioned before, there are still concerns with respect to U.S. taxpayers within these arrangements.

A company sets up and establishes a Retirement Compensation Arrangement, an RCA trust, but rather than depositing the value of the liabilities that are accrued to date, it will instead negotiate with a financial institution for the purchase of an annually renewable letter of credit. This letter of credit will be purchased with a face amount equal to the liabilities of the plan. The company will make contributions in the amount of twice the letter of credit fee. Because it is an RCA, one-half of this contribution is going to the federal government to be held in the refundable tax account and the other one-half of the contribution is being used by the RCA trust to purchase this letter of credit. Within that one-year period, should a triggering event occur, such as the failure of the company to pay benefits, the insolvency or bankruptcy of the company, or the failure of the company to renew the letter of credit, the letter of credit will trigger, with the assets being contributed into the RCA trust fund in order to provide the security for those benefits.

In practice, these letters are rarely triggered. The company continues to pay benefits directly from payroll and purchases each year an increasing letter of credit, because liabilities are typically going up. One of the pitfalls of the letter of credit is the fact that they are renewable each year, and the fees are reset each year. A company may find that a letter of credit is an inexpensive form of benefit security for a very strong financial company. As the financial condition of the company deteriorates, the letter of credit fees get more and more expensive and put pressure on the borrowing capacity.

If and when the letter of credit is triggered, the financial institution becomes a creditor and will look to the company for repayment of the face amount. The bank will approach the company for repayment of the face amount at a time when the cash reserves and the cash uses are already tight. Both the funded RCA and the letter of credit have advantages and disadvantages. Making sure those advantages and disadvantages are known by a client up front is critical.

MR. FREDERICK: To summarize what we've gone through, about one-half of the plans on the U.S. side are unfunded, while roughly about 40 percent are funded with rabbi trusts. That 40 percent can be a very deceiving statistic because a large number of those rabbi trusts are what we classify as "springing" or "triggering" trusts, where there physically aren't assets set aside in advance, but those monies will be set aside upon change of control or other contingent events. The remaining 10 percent involve the use of deferred annuities or employee grantor trusts and, as I'll discuss later, the use of split-dollar life insurance as a funding vehicle.

MR. CLAUSEN: In Canada about 60 percent of plans are unfunded and unsecured. Of those that are funded or secured, the RCA and the letter of credit are the two preferred vehicles, with various other security methods making up a very small percentage of the methods that are used. With respect to choosing between funded RCAs and letters of credit, about 25 percent of the plans in our database are using funded RCAs in order to secure benefits and about 13 percent are using a letter of credit. One of the important deciding elements is the employer's corporate tax rate. The reason is that the RCA is essentially a 50 percent tax environment for invested assets. The letter of credit itself has no invested assets; it is an annual renewable fee, but a fee that is lost once it is paid. You will reclaim the refundable tax, but many years into the future. For companies that pay little or no tax, the value of the tax deduction on the contribution to the RCA provides little value. We find that companies that pay little or no tax tend to lean toward the letter of credit because it uses up the least cash flow in the early years. Companies that pay near the highest levels of corporate taxes often lean toward funded RCAs. Also, when you start looking at shifting money from the highest corporate tax rate to a 50 percent RCA tax rate, there is a much smaller difference in corporate taxes versus RCA taxes.

More companies are starting to recognize that whether a plan is unfunded, funded in an RCA or secured through a letter of credit, the tax advantages available for

registered plans do not exist. Assets are either in a corporate tax environment or in an RCA tax environment, neither of which is subsidized.

MR. FREDERICK: We'd like to focus on what has already happened in the last couple of years regulation-wise that affect these benefits and then attempt to get our crystal ball out and say what trends we see happening over the next few years. I'll begin with the U.S. side.

President Bush has been a busy man. In 2001, we had a Tax and Pension Reform Act that did three things. First, it substantially increased the limit on the level of benefits from qualified pension programs. Second, it enhanced elective deferral options in 401(k)-type programs. Third, it put in motion a series of reductions to federal income tax rates that was scheduled to occur between 2001 and 2006. The immediate impact to the SERP side from this tax act was twofold. First, because the qualified limits went up, you immediately had a shift of benefits from the SERP back to the qualified program. For employers that earmarked assets in aggregate with the rabbi trust, they were overfunded. For employers that had funded on an individual basis with annuities or through a grantor trust, which is a difficult transaction to reverse, they were overfunded as well. This created a lot of interesting problems and challenges in 2001. The other impact is that the decrease in federal tax rates made companies modify tax-adjusted strategies, such as for a deferred annuity.

In 2003, they hit again with another tax act that took the federal tax rate schedule that was put in place in 2001, scheduled to be done by 2006, and crammed it all in 2003, so the decrease in federal tax rates became accelerated. Furthermore, it reduced, from an individual taxpayer point of view, the tax rates that apply to capital gains and dividends. The biggest impact it had here was to make individuals look at the economic merits of pre-tax deferral programs—a qualified 401(k) or a non-qualified deferral program—and ask, am I better off taking my money now, paying my taxes, and investing and being taxed at these more favorable dividend and capital gains rates? Or am I better putting it into the 401(k) plan and being taxed at higher ordinary income rates at the back end? It is a tough decision. Removing the security issue of it, I still think pre-tax deferral has a lot of merits and is advantageous for an individual. But in a nonqualified environment where those benefits are at risk and you add the security issue to it, it is a tough decision. From my own point of view—I'm in my early 30s—I have a hard time deferring my own bonus into a nonqualified plan that I'm going to receive 30 years down the road. My company is solvent, it's doing fine, but things happen, and I think this made people take a closer look at that.

The other area that's happened in the United States is split-dollar life insurance. This is probably the most complex area I work in.

In simple terms, split dollar is very prevalent. It's been used for 50+ years to predominantly provide post-retirement life insurance coverage for key executives.

In certain instances we see it fund SERP benefits. If I were to poll the Fortune 100 companies, probably split dollars are found in about 75 percent of them in one form or fashion.

If I were to push away all the complexity, split dollar in essence is an interest-free loan. You take an insurance policy that the individual owns. The employer agrees to make all the premiums or put up the capital investment. Then, usually 15 years later, the employer will pull its money out without interest, lets the individual keep all that gain or investment earnings, and that funds the post-retirement life insurance benefit.

Historically the tax treatment in the interim to the individual was minimal, just a simple slap on the wrist. However, prospectively, through a combination of IRS notices in 2001 and 2002 and then final regs that came out in September of 2003, the IRS said these arrangements are going to be one of two things: you're either just providing a death benefit and they're going to tax it that way under the group term rules (Section 79), or if there is an arrangement where at some point the executive is going to get cash, they're going to tax it in one of two ways. They're either going to tax it along the way as an interest-free loan and impute interest to the individual or they're going to tax it at the rate the individual has access to that cash value. In simple terms, there's no free lunch on this one. However, I will offer a caveat that there are degrees of grandfathering for arrangements that have already been in place. In some instances continuing on the split dollar does make sense, but given our time constraints here and the level of complexity, that's all I'm going to go into.

MR. CLAUSEN: On the Canadian side, there is very little that has been changing with respect to regulations. The only point to note is the fact that the maximum pension limits for registered pension plans are going up in 2004 for the first time in more than 25 years. This increase is resulting in a shift in benefits and liabilities from the non-registered supplemental plan back to the registered plan.

MR. FREDERICK: We thought it would be best for each of us to focus on what we think will be hot areas for the next few years. In the United States, I think it could be summed up in three areas. One area is, from the participant's perspective, the huge increased concern over the security of these benefits and whether or not he or she will receive them. The second area is that, in return, the company—the compensation committee and the board—is dealing with a very tough issue when addressing the level of funding of these SERPs due to the increased shareholder activism and media attention around these benefits. The third area is that then from Congress' point of view, in light of the Enron hearings and all the stuff hitting the press, there is a lot of pressure to put out what people call "deferred compensation reform" to look at certain practices that are perceived as abusive.

On the security issue, from the executive's point of view, a culmination of events has happened over the last few years. With the difficult stock market, many

executives have seen their stock options lose value or effectively be under water and worthless. Second, their own voluntary savings through 401(k)s and other deferral mechanisms are deflated, and it's made them shift focus toward these traditional benefits—these SERPs and restoration programs. For some individuals, this might represent 90 percent of their retirement benefits. The problem has been further magnified by the collapse of historically stable firms such as Enron and WorldCom, and then you have certain industries that have unique business risks. For example, the airline industry is prone to terrorist acts. The tobacco industry is litigation-prone, which is also true for the oil industry. I've seen executives in the airline industry argue, "I could do my job great. I could meet all my measures. I could run the best airline company in the country, yet all it takes is one person to steal one of my planes, the whole company goes bankrupt and I lose everything. Is that fair?" I don't think there's a simple "yes" or "no" answer, but I understand their argument, which brings me to the next area.

The company hears the request of the executives to address the security and the level of these benefits. But on the other side, the company hears the shareholders yelling and the media attention around these benefits. I get calls daily from clients who say, "Please tell me I don't have one of those bad SERPs." I'd love to say that it's a simple one-sentence answer. I'd be willing to wager that every major company in the United States on the Fortune 100 has plans next year to audit its executive pay and benefit packages to make sure it feels like it's on the right side of the fence. So we see this enhanced spirit of governance where I see companies doing two things. First, they want to say historically how they got to where they are now. They want to make sure they properly document what they've done and that they properly disclose it. Then they want to do an audit to make sure they're comfortable with their position. Going forward, they need appropriate checks and balances in the approval process for executive pay and executive benefits, which has considerably changed the board's role as compared to the past. Historically, the buyer of consulting services could be the management team and the same people that would benefit from these SERPs. More and more I'm seeing where, with the consultant's relationship with the board and the compensation committee, there's a stone wall between consultants and the executives. Lastly, there's this big push to say momentum-wise they want to be consistent with other changes they make in their organizations. If they go to all their employees and say they're decreasing future retirement benefits and taking away post-retirement medical, while keeping executive benefits at the same level or funding them at a rate higher than their current qualified pension plan, it's problematic. So they're trying to strike this sense of consistency.

The last area is momentum from a regulatory point of view. There are three areas that are looming out there: voluntary deferred compensation reform, enhanced disclosure from the SEC, and the potential disallowance of the use of COLI as a tax shelter. Regarding the first area, the Thomas Bill is looming out in Congress. One of the senators is quoted as saying, "The game is over." The quote was made after

the Enron hearings and was magnified by the media attention. This gave a lot of momentum to look at SERP plans and voluntary deferred compensation.

What's on the docket now is predominantly focused toward voluntary deferred compensation. In simple terms, it's looking at restricting the ability to pick and choose when you want to receive your money, to push dates out and to accelerate it. It's looking to restrict the ability of key executives to leave a company in anticipation of bankruptcy and receive payments. (There may be some waiting period.) Furthermore it's saying from an investment or attractiveness point of view, the investment options can't be more attractive than the underlying 401(k) we offer to all our employees.

One other interesting aspect of this bill is the potential repeal of IRC Section 132. Section 132 has effectively frozen the tax laws that apply to deferred compensation plans since the late 1970s. The bill would give the IRS the ability to rewrite and revisit these laws, which would change our world significantly.

The last area of focus is the use of rabbi trusts, particularly off-shore and domestic trusts that might trigger upon certain events. My personal feeling of the likelihood of this being passed in the next year is probably 50 percent, and, if it is, it would be on a prospective rather than a retrospective basis.

The next area, which I think has a 100 percent chance in some form or fashion of being adopted in the next couple of years, is enhanced proxy disclosure of SERP benefits. There's discussion of, in addition to the pension table and the compensation table for the top five officers, disclosing the lump sum value of their SERPs, and, in addition, disclosing the account value of their own voluntary savings through qualified and non-qualified arrangements. These are the areas that have grabbed the media's attention and have given people what we call "sticker shock." Whether it comes out formally by the SEC or voluntarily from employers, I think there's a 100 percent chance this will change.

In the last area, you may have seen proposals out there to disallow companies to use COLI as a funding vehicle. My personal bet on that is there's no chance that will happen in the next year for two reasons: one, the insurance lobbyists are too smart and too powerful, and, two, no elected official in his or her right mind would attack COLI in an upcoming election year. It might be something that comes back up two or three years from now, but not in the short term.

MR. CLAUSEN: With respect to the Canadian trends, as with the design of the benefits themselves, Canada and the United States are following very similar paths and similar expectations in the future. Essentially, everything that Doug has just said with respect to shareholder and media attention, and with respect to increasing levels of corporate governance and increasing disclosure requirements, will likely occur in Canada as well as in the United States. You are likely to see a lot more focus with respect to who can design SERPs, who can be entitled to benefits, how

large the benefits get and how thorough the disclosure is in the annual proxy statements for the top five executives. There is pressure to increase disclosure, increase understanding and to put a dollar value to SERPs for the board of directors. Two very similar plans for disclosure purposes can have vastly different values based upon plan provisions that are not required to be disclosed. There will be pressure toward better understanding what these plans are and what they're worth.

I will summarize a few trends in plan design that we have been seeing in Canada.

The first trend is benefit eligibility. As I mentioned earlier, one of the trends we find in Canada is that more and more companies are offering SERPs to a greater number of employees, whether it means taking the eligibility level down from an executive vice president to a senior vice president or down to a vice president. There has also been an increasing number of restoration-type SERPs extending eligibility to any employee who is affected by the maximum pension limits.

One of the drivers pushing down the eligibility is that the number of members affected by the limits is getting larger and larger. As the limits start increasing, assuming that they continue to increase, these increases could either accelerate or reduce the trend of offering restoration-type SERPs to all individuals. With fewer people affected, the dollar impact of covering all employees becomes much smaller. However, with the limits increasing, the pressure on the company to provide a restoration-type SERP may also fall as the portion of the benefit over the maximum has decreased.

On the issue of security for defined benefit SERPs, the trend over the last five years shows not a dramatic increase, but a slow and steady growth of companies that are providing some form of benefit security. The security is primarily either a funded Retirement Compensation Arrangement or a letter of credit that is held in an RCA.

With respect to vesting, we are seeing increased vesting if an individual should terminate before retirement. Historically, SERPs were looked at as an enhanced executive benefit that was very generous to those who made it to retirement but provided nothing to those who terminated before retirement. We are seeing a trend toward benefits being vested for members who terminate employment before retirement.

The purpose of the SERP is still an important criterion in determining the appropriate vesting. As an example, most plans vest benefits to members when they terminate if those benefits are of a restoration type, where the SERP simply provides the benefit the member would have gotten had the maximum benefit limit been higher. If the SERP provides an enhanced benefit for only long-service individuals or benefits for only a handful of senior executives, strict vesting criteria are often still applied. I have recently seen some step-rate formulas where, for even the most senior executives, such as the CEO, benefits vest up to a

restoration-type SERP, but any enhancements over and above the restoration-type SERP will be forfeited if termination occurs. SERP arrangements are being viewed more and more as a part of compensation for service that has already been accrued. This view is driving both the funding and the vesting of SERPs as opposed to being considered a perk that you may or may not receive some day down the road.

MR. FREDERICK: In closing, the design and funding of these plans can be very challenging and creative. It's striking a balance among the executive needs, the company cost, the shareholder or media attention and consistency with broad-based employee programs.

MR. LES STRASSBERG: This is a question about a practice that I have heard is taking place with greater frequency here in the United States, which is a SERP shift. In essence, a SERP shift is a restoration plan where the underlying defined benefit plan gets amended (to the extent that it's not already too top-heavy) to increase executive benefits to the maximum extent possible. I was just curious what your observations are with regard to employers that are doing this SERP shift.

MR. FREDERICK: That's an excellent question. I left it off the universe of options, but that is a legitimate approach you see people take. The term you'll see is the "QSERP," or Qualified Supplemental Executive Retirement Plan, where they write within the qualified plan document that certain participants either receive a higher accrual rate, additional years of service or an additional benefit. They can do so up to the qualified plan limit, the 415 benefit limit. Someone with 10 years of service, who's age 62 or above, can in theory get $160,000 out of the qualified pension plan. The challenge with that is that you still have to pass your discrimination testing. That's where I've seen some employers say that this will work, but that it's a partial fix. It will work for a handful of executives. I've seen one of two strategies. The first strategy is to try to grab the biggest part of the liability first. Grab a handful of people and maximize them through this QSERP idea. Other companies take the approach that will try to maximize the number of people. Part of it depends on other strategies they have going on to fund the benefits. That is a legitimate approach we do see, but it is complex to do the testing and to administer it.

MR. CHRIS TOMEV: Are there any data on increases after retirement for indexation? The other question I had is related to things that were alluded to in terms of the lump sum calculations. There seems to be a lot of volatility in those, but not a lot of data as to whether you're grossing up for tax or not grossing up for tax. Also, there aren't a lot of data on enhancing the value so that you can outright settle it. Could you comment on that?

MR. CLAUSEN: These are a couple of areas that we originally intended to discuss but were removed in order to keep the presentation to the allotted time. With respect to the issue of indexing, I have typically found, in perhaps 75 percent to 80

percent of the cases, that the indexing provisions of the SERP mirror or follow the registered plan provisions. Currently, automatic indexing in the private sector in Canada is extremely rare. Indexing tends to be ad hoc, if anything. In these cases, we see the ad hoc provisions carried over into the SERP, but that's by no means universal as a requirement.

In the registered plan, you are permitted to index benefits up to 100 percent of CPI. Some plans will index benefits in the registered plan at 100 percent of CPI until those benefits reach the level of what would have been paid at retirement had no limits existed. In other words, every year the company recalculates how much the registered pension should be and shifts liabilities from the supplemental plan into the registered plan through a process of indexing only members who are affected by the tax limits. I have seen a few companies using this technique to maximize registered plan benefits. It is extremely complicated to administer. Some companies also add ad hoc cost-of-living adjustments on top of the total pension when these adjustments are granted to all other employees. While this is a possible strategy of transferring liabilities that some companies use to maximize how much can be paid from the registered vehicles, the majority of plans tend to maximize registered plan benefits only at retirement.

As with all provisions, the SERP documentation is important with respect to cost-of-living adjustments. Some companies are required to provide cost-of-living adjustments in the SERP based on what they provide under the registered plan, depending on how their SERP document is worded. Other documents are quite specific that the decision to index a SERP and the decision to index a registered plan are two completely separate decisions and need separate board approvals.

With respect to tax adjustments, this is another area where the practice is all over the map right now. It is also an area we could spend an hour discussing. As background, I would have to say that the majority of SERPs do not offer portability, although more are now offering this option. For plans that do not offer portability, the issue of tax adjustments is very rarely documented. For SERPs that offer portability, if the lump sum payment is being elected by the member, it is rare for that payment to include any kind of tax adjustment. Often this is done because it is a voluntary election by the member to receive the lump sum when a pension option was also provided. Members are given a choice of "A" or "B," and if they want the lump sum, then that lump sum, with some exceptions, tends to be based upon the same interest rate basis, mortality tables and actuarial assumptions as the registered plan without a tax adjustment. Communication is important in this area, as the executive needs to understand there is no tax adjustment built into that value.

Practice varies when the portability is forced by the employer. There are two different directions. There is an employer that is bankrupt, and then there is an employer that unilaterally decides it does not want to provide a SERP benefit anymore. In most cases, I find that the documentation refers to no tax adjustment.

In other words, the commuted value is based on the same basis as the registered pension plan. However, I have not seen an employer able to voluntarily wind-up with no tax adjustment without going insolvent. The reason is that the employer has made an obligation to provide a certain pension to an individual. If the employer wants to back out of the obligation and settle with a lump sum, the employer will most likely find itself in court defending its actions and having to justify a non-tax-adjusted basis. The member's argument that the lump sum will not be able to replicate the benefits promised based on the voluntary actions of the company may be difficult to defend against.

The other side is the insolvent employer. Some employers state that their objective, if they cannot provide the benefit because of company bankruptcy, is that there should be sufficient assets to provide the full benefit that the member would have received had the company continued to pay benefits. Therefore, these companies take the approach that this must be a tax-adjusted commuted value.

The other extreme is the employer that states that funding benefits for supplemental plans is voluntary, as is having a SERP. If there was no funding and the company went insolvent, individuals would be receiving nothing. The company has made a choice to fund the benefit and they are funding it on the same basis as the registered pension plan. It is the tax authorities and the limits the tax authorities place on RCA payments that do not allow these benefits to be transferred to a RRSP. These companies argue they are meeting their obligation by paying the commuted value.

Other employers have used the argument that, in Canada, not only is there a benefit limit, but there is also a limit on how much of a registered pension can be transferred to a RRSP or other tax-deferred vehicle when you terminate employment. I have never witnessed an employer top up any taxable cash payment that must be made from a registered pension plan because it exceeds these transfer limits. Some employers use the argument that they are not going to tax adjust the SERP for the same reasons they do not tax adjust these registered plan benefits. As mentioned earlier, practice in this area is definitely mixed, and the biggest concern is that most documents only deal with voluntary terminations. Few documents describe what happens if the SERP winds up. This should be documented, but it rarely is.