

WHITE PAPER

A guide to designing key employee compensation strategies with life insurance



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BACK COVER

Top talent can greatly contribute to business success, but how can employers – especially small- to medium-sized businesses – attract, retain, and motivate this type of employee? Life insurance can be a dynamic solution, and for agents, it can be a valuable tool to offer business clients to power executive recruitment and retention programs and create innovative benefits packages.

Through initiatives such as executive bonus plans, split-dollar arrangements, and nonqualified deferred compensation programs, businesses can use life insurance policies as part of an effective key employee acquisition and retention strategy.

This white paper will share professional insights on how life insurance policies can support recruitment and retention strategies, including insights on which policies and products are best suited for different businesses and goals.

It will also discuss which benefits experts and other professionals can support employers to create these key employee plans.



Indexed Universal Life (IUL)

With its death benefit protection, accumulation potential, and the opportunity for loans and withdrawals, IUL can be a valuable tool for small businesses to address key employee compensation, business succession, and business-owner estate planning strategies.

The advantages of key employee compensation plans

Initiatives such as executive bonus plans, split-dollar arrangements, and nonqualified deferred compensation programs are powerful tools businesses can use to build innovative benefits packages that attract top talent and incentivize key employees to remain with an employer for a long period of time.

Employers typically design these plans for one or more highly compensated employees in an organization as a fringe benefit, rather than a standard benefit plan offered to all employees. Because they create strong incentives for employees to stay, these types of compensation plans are often referred to as “golden handcuffs,” especially when they require achieving specific vesting or time conditions in order to receive the full amount of the employer’s contribution to the plan.

These compensation plans are almost exclusively funded with cash value life insurance, which offers a variety of benefits for both the employer and the executive.

It’s not unusual to see large, publicly traded companies offer these types of insurance-funded, nonqualified benefit plans to C-suite executives. However, small companies – which employ nearly half of the U.S. workforce¹ – may also find advantages to offering these types of plans to attract talent to their organizations.

¹ Source: <https://www.uschamber.com/small-business/small-business-data-center>.

EMPLOYER BENEFITS

Employers can benefit from the versatility and flexibility of these plans, which can be customized to attract or retain a particular individual candidate. Some of the main advantages are highlighted below:

1. Generous incentives for talent acquisition and retention

These plans can become a powerful talent acquisition and retention tool, especially for top executive talent. Offering a generous executive bonus or split-dollar arrangement funded by a tailored life insurance policy can help companies distinguish themselves from their competitors. They can customize these compensation plans to an individual executive and their specific needs.

For example, a life insurance strategy that only pays a death benefit might not be a strong incentive for an individual with no spouse or dependents. However, a strategy that is structured to build cash value in a life insurance policy early and later provide the beneficiary with supplemental retirement income might be very attractive to a single person, especially one who doesn't have a spouse's retirement income to supplement their own. It is important to note that a life insurance policy does not provide a stream of income in retirement. Supplemental retirement income may be available through policy loans and withdrawals, assuming the policy has sufficient cash value.

2. Discretion to limit offerings to highly compensated employees

Employers can be selective about offering these types of compensation plans. Qualified plans, such as 401(k) or 403(b) plans, must be made available to all eligible employees and must

adhere to the requirements of the Employee Retirement Income Security Act (ERISA).

However, nonqualified executive benefit plans can be provided as an additional incentive as they allow employers to specify which employees receive these types of compensation benefits. Nonqualified plans must also be limited to highly compensated employees or select management-level employees.

3. More efficient funding sources for benefits

Using life insurance to informally fund these plans allows employers to avoid funding the plan entirely with cash. They can leverage the life insurance to provide a bigger death benefit than they would pay in a cash bonus, for example, or to hedge against the future liability of paying deferred compensation.

These nonqualified compensation plans may also allow a smaller employer to use a life insurance policy for the potential to provide supplemental retirement income to attract top talent or fill key positions. Many smaller employers are limited in the types of qualified benefit plans they can offer employees, and may not even be able to offer a 401(k) plan. Although it is not a source of guaranteed retirement income, using life insurance to complement traditional retirement income vehicles can enhance their acquisition and retention strategy.

4. Key employee insurance

Employers may be able to use an insurance policy as key employee insurance. A life insurance policy can be used to provide the business with generally income-tax-free death benefits to cover financial losses, recruit a replacement, or even pay off debts if a key executive dies.

EMPLOYEE BENEFITS

For current or potential employees, funding a nonqualified deferred compensation plan with life insurance can be a strong and lucrative incentive to maintain or accept a key role at an employer, especially when a strategy is specifically tailored to their situation. Some additional advantages to various types of nonqualified plans include:

1. A potential source of supplemental retirement income

Because of its unique tax advantages, cash value life insurance can provide the opportunity to supplement retirement income. Strictly cash value life insurance, such as an indexed universal life policy, can accumulate value on a tax-deferred basis. The executive has some flexibility in how to access that cash value, such as taking out an income-tax-free policy loan in which the loan would not be considered taxable income in the year that they borrow it. (An individual utilizing a loan strategy should carefully manage policy values to prevent a lapse and unintended tax consequences.) Alternatively, they can withdraw funds from the policy to supplement their retirement income on a tax-advantaged basis, even though this would reduce the death benefit amount.

2. Death benefits for dependents

Life insurance provides death benefits paid to the executive's named beneficiaries that are generally income-tax-free. Depending on the amount of the cash value policy, this can

provide substantial financial protection for the employee's family in addition to any group-term life insurance plan the employer may offer, which typically only pays one or two times the employee's annual salary. If the employer helps to purchase additional cash value life insurance for key employees, it may have a competitive advantage over other potential employers. This would be especially valuable to potential employees with children, a spouse who doesn't work or earns substantially less, or other dependents.

3. Ownership and portability

In many of these arrangements, the employee or the executive owns the policy, meaning the coverage is portable if they leave the employer. Sometimes the employer will place limits on that flexibility, such as with a restricted executive bonus arrangement. The employer can include a vesting schedule as part of the plan, for example, requiring the employee to remain with the employer for a minimum amount of time before having access to the cash value or the total death benefit.

4. Estate planning strategies

Life insurance can be an effective tool for estate planning strategies by providing the opportunity of liquidity to cover estate taxes and maximizing the legacy gift that's left to beneficiaries on a tax-advantaged basis.

Effective **key employee** compensation strategies

There are a variety of ways to structure a key employee compensation package using cash value life insurance. Deciding which strategy to use depends on the employer's objectives. This can be set at a plan level, adjusted by the level of key employee, or even customized for an individual potential employee.

Although employers can fund these strategies with whole life insurance, indexed universal life is often an effective choice because of its flexibility and versatility and the fact that IUL policies are often designed to provide accumulation potential that can be accessed through policy loans and/or withdrawals for various financial purposes. (See sidebar.)

Businesses can decide which type of life insurance product to use based on their goals and whether the intent is to have the employer or the employee own the policy.

For instance, if the goal is to provide an employee with the opportunity to supplement retirement income, a policy with the potential to accumulate funds faster in the earlier years of that policy may be an effective choice. If rewarding key employees is the objective, providing life insurance as part of an executive bonus plan is a more likely choice. And if retaining a key executive is the primary objective, long-term incentives with certain vesting requirements may be the best choice.

Income tax considerations and premium costs for both the employer and employees are also critical to determining what type of initiative to offer. For example, in an executive bonus plan, the employer typically pays the premiums directly, which can carry a significant tax advantage for the employer as well as provide reassurance that the policy premiums are paid. Another option is a split-dollar arrangement, in which costs of premiums as well as the potential benefits of the life insurance policy are shared between the employer and the employee.

Indexed universal life for small businesses

Indexed universal life (IUL) insurance is a cash value life insurance policy that provides a death benefit but also has the potential to build accumulation value over time based on an external market index or fixed interest allocation. Therefore, it has greater potential for additional accumulation than traditional universal life policies. An IUL policy also allows a policyholder to access cash value from the policy via loans or direct withdrawals.

Small-business owners in particular may find that IUL policies can be an effective choice for funding supplemental compensation plans because of two key advantages.

1. Flexible timing of premium payments

With a traditional whole life policy, if a premium payment is missed, there's a risk that the policy could lapse. But premium payments are more flexible with IUL policies, as long as sufficient premium is paid to keep the policy in force, which can be an advantage for small businesses that may have less predictable cash flow or income over time.

2. Exposure to market performance

Small-business owners tend to have a somewhat higher tolerance for risk than large corporations. IUL policies offer a level of market index exposure that can mean potentially higher accumulation potential, although not a guarantee of better-than-average interest credited to the policy.

The accumulation potential of IUL grants small businesses the ability to create an attractive compensation package for potential key employees or highly sought-after candidates.

Common initiatives and strategies

EXECUTIVE BONUS PLAN

The executive bonus arrangement, also known as a Section 162 plan, is a common choice for a benefit funded by life insurance. This type of plan covers the employee and may also provide some protection for the employee's family members, while providing the employer with a flexible and effective incentive tool.

Executive bonus plans are designed to retain and recruit key employees by providing tax-advantaged supplemental income or retirement benefits. An executive bonus plan offers several incentives, including immediate cash value accumulation as well as a death benefit component that's paid for by the employer.

These plans are simple to set up and generally include an agreement drafted by the employer's attorney. In an executive bonus plan, the employer pays the premiums for the insurance policy, which is effectively bonus compensation to the employee. The employee typically owns the policy outright, making it an attractive, portable benefit that they can keep if they leave the employer. Although the employee would then be responsible for paying the insurance premiums at that point, they still retain the benefit of what was previously contributed from their employer.

On the employer side, these bonus plans involve less complexity and fewer transactional costs than other types of employee-sponsored plans – for example, a 401(k) plan, which requires a plan administrator at additional cost.

SPLIT-DOLLAR ARRANGEMENTS

Another common type of plan, the split-dollar life insurance arrangement allows the employer and the executive to divide the obligations and the advantages of the life insurance policy. For example, in a typical split-dollar arrangement, the employer and the executive each pay part of the premiums but also share the cash value or the death benefit. A split-dollar arrangement is appealing because it can help executives purchase a life insurance policy that might otherwise have a very high individual premium cost. There are also tax advantages to the employee, including tax-deferred growth of policy accumulation values and a generally income-tax-free death benefit.

There are a couple of variations of the split-dollar arrangement. In one version, an employee owns the policy, but the employer pays the premium and retains the right to recover its premium outlay via the cash value or proceeds from the death benefit. In another variation, an employer owns the policy but endorses a portion of the benefits to the employee's designated beneficiaries. The employer decides which variation to use, often depending on cost and tax considerations.

NONQUALIFIED DEFERRED COMPENSATION

Another popular type of executive benefit plan is the employer-sponsored, nonqualified deferred compensation plan. In this strategy, the employer owns the life insurance policy and then uses the cash value or death benefit to fund the obligation to the executive as per an agreement between the employer and employee. Usually, these types of agreements are reserved for highly compensated key employees, although they can also be offered to all employees at or above a certain executive pay grade or management level.

With a nonqualified deferred compensation plan, a certain percentage of income is deferred until future years. The employee pays tax on that income the year it is actually paid to the employee. The life insurance cash value and death benefit provide the funding mechanism for the plan. This is designed to ensure that the employer has a source of funds from which to pay, or at least subsidize, the employer's obligation to the executive when they retire or otherwise leave the employer. When such an event occurs, the employer may choose to use the cash value or death benefit proceeds of one or more employer-owned life insurance policies to pay the deferred compensation owed to the employee or their beneficiaries.

Employers can also provide an additional layer of protection for nonqualified deferred compensation plans by implementing certain types of trusts that set aside funds to fulfill the plan's promises. A rabbi trust, for example, is a common choice. Originally

used to compensate clergy in a synagogue, a rabbi trust sets aside the amount needed to fund the compensation plan. The employer cannot use these funds to pay general obligations. However, the rabbi trust is still available to creditors of the employer if the employer were to become insolvent or bankrupt.

Another type of irrevocable trust to consider is a secular trust, which is designed to be bankruptcy-proof as the funds are protected from the employer's creditors. However, immediate taxation is triggered for the employee upon vesting, which makes this a less common option in many cases.

Yet another nonqualified bonus option is a Restricted Executive Bonus Arrangement (REBA), which is a prime example of golden handcuffs. In a REBA, the employer pays for the key employee's life insurance policy, but the plan is restricted by a legal agreement that prevents the employee from accessing the cash value until a specific future condition, such as time-based vesting, is met. This type of plan incentivizes the employee to remain at the employer, or they may risk forfeiting some of the benefits they might otherwise be entitled to receive.

Key professionals for planning

Several key professionals are instrumental for companies that want to build and offer these types of compensation plans. First, businesses will want to consult with an attorney who has experience in drafting these compensation agreements.

Companies will also want to consult with their individual tax advisor, who is responsible for filing the business corporate tax returns. There are several filing requirements involved, particularly in cases where the employer owns insurance on the employee (*see sidebar*). Plus, it's critical for the tax professional to understand the tax details as well as the tax advantages involved with each type of plan.

Finally, an experienced insurance professional is critical to helping the employer select the type of life insurance policy used to fund the plan. The insurance professional is also key to helping employers understand how to determine the death benefit and how premiums should be paid. The agent will also make sure all agreements and endorsements are clearly defined and executed. An insurance professional can also lead the process, creating a checklist of documents and tasks to ensure all responsibilities are assigned accordingly to each professional assisting the employer and then following up to ensure that all items are completed.

Requirements for businesses that purchase life insurance on the life of an employee

Businesses that purchase life insurance on the life of an employee must be aware of IRS filing and reporting requirements that are part of the Pension Protection Act of 2006. The IRS now monitors on which employees businesses are purchasing life insurance.

First, any time an employer acquires life insurance on the life of an employee, or any of its officers and directors, it is required to notify the employee in writing that the employer is purchasing the policy before the coverage is obtained. It must also provide the maximum face amount for which the employee could be insured at the time the policy is issued and inform the employee that the employer will be a beneficiary of any proceeds payable upon the death of the employee. The employee must also sign a corresponding acceptance or consent to be insured and that such coverage may continue after the insured terminates employment. All of these notice and consent requirements must be met before the policy is purchased. It is important to note that life insurance requires qualification through health and financial underwriting; insurability of the employee is a key factor in the execution of these strategies.

In addition, every year that this life insurance is in force, the employer is obligated to file IRS Form 8925, which is used to report employer-owned life insurance contracts. These requirements can be found in Section 101(j) of the Internal Revenue Code. Clients should consult with their tax advisor and/or attorney to discuss their specific needs and situation.

Conclusion

A well-designed key employee compensation strategy allows companies to offer something of tangible value to potential employees. Utilizing high-end financial perks such as executive bonus plans helps companies stand out among other competitive firms, which is critical to attracting top talent.

In order to build an effective executive compensation plan, businesses must first define and understand their recruitment and retention goals. Business owners should consult with their team of professionals to help ensure their specific financial, legal, and tax considerations are addressed. Insurance professionals can provide resources to support business clients as they determine which compensation plan programs and strategies can best help them accomplish their goals for recruiting, retaining, and motivating their key employees over time.

Clients should consult their own legal counsel to ensure that any agreements meet their specific needs and comply with applicable laws and regulations.

Allianz Life Insurance Company of North America does not provide financial planning services.

Indexed universal life (IUL) insurance policies provide a death benefit that is generally paid income-tax-free to beneficiaries, and the potential to build tax-deferred accumulation value. IUL requires qualification through health and financial underwriting.

IUL does not provide a guaranteed stream of income in retirement. Supplemental retirement income may be available through policy loans and withdrawals; there is no guarantee a policy will earn sufficient interest to support a loan strategy.

When using a loan strategy, it is important to monitor policy values to help prevent a policy lapse and unfavorable tax consequences.

Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and you should consult a tax professional.

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