Allianz Life Insurance Company of North America

LIFE ADVANCED MARKETS

Building an effective key employee compensation strategy

"Start with good people, lay out the rules, communicate with your employees, motivate them and reward them. If you do all those things effectively, you can't miss." – Lee Iacocca

Chances are the success of your business relies, at least in part, on the talents and performance of your employees. And while each employee is important, there may be a few who are key to attaining your business objectives. Just as each business has a value proposition it offers to prospective customers, the total compensation package you offer key employees is part of your value proposition to them.

There are many different forms of compensation and benefits an employer may offer to retain, recruit, and motivate the talent they need to succeed.

IMPORTANT POINTS TO CONSIDER

Like any other business decision that requires an allocation of financial and human resources, it is important to take a strategic approach.

Define and prioritize goals

Before committing financial resources, it's important to determine exactly what your goals are.

Is your business a start-up that needs to quickly attract top talent? Is it an established business concerned with retaining employees who would be difficult to replace? Or are you looking for an effective means of motivating key employees to increase profits? If you have multiple goals, which one has the highest priority?

The more specific you are about those goals, the better. For example:

- We're looking to sell the business within 4-5 years and need our employees to drive revenue until the sale occurs in hopes of driving the stock price higher.
- Our business requires consistency at the top, so we would like to reward company loyalty.
- We need to attract employees with a unique skill set and knowledge so we can expand our business into new markets.

Decide who is "key"

Before allocating financial resources to a key employee compensation package, take the time to determine which employees truly are key to the ongoing success of your business.

- Do they have long-term, trusted relationships with key clients that would take many years for their replacement to develop?
- Do they have unique knowledge or skills specific to your industry or regional market?
- If they were to terminate their employment, would they pose an immediate risk as a competitor?
- If they were to terminate their employment, would other talented employees chose to leave with them due to a close relationship?

The compensation arrangements discussed below allow the employer to be selective in choosing which employees may participate, the amount of any employer contribution, the length of any vesting schedules, performance goals which need to be met, and other design features. There is considerable flexibility. A number of the compensation arrangements actually require the plans to benefit only a select group of highly compensated employees or management.

TAILOR THE PLAN TO THE INDIVIDUAL EMPLOYEE

What motivates one employee may not motivate another. A married 35-year-old making $80,000 per year who just had a third child will be much more appreciative of employer-provided cash value life insurance than a 60-year-old single employee making $400,000 per year who has no children.

An employee making $120,000 per year with a total household income of $150,000 may not appreciate the tax advantages of a deferred compensation plan, but another employee making the same amount with total household income of $400,000 may greatly appreciate such a plan.

If the compensation doesn't motivate or incentivize a particular employee, you risk wasting financial resources.

COMMUNICATE THE BENEFITS OF THE PLAN

As with any financial outlay, you should expect a return on your investment. In the case of key employee compensation, the expected return is more effective, better performing, harder working, and more loyal employees.

A common mistake made by employers is assuming their employees understand and appreciate the different forms of compensation the employer provides. To maximize your return, it is important your key employees fully understand these additional forms of compensation, how they work, and what benefits they receive from them.

Select the appropriate strategy

Here are the more common forms of key employee compensation strategies, and their advantages and disadvantages.

Bonus Plan

An annual cash bonus is a simple and flexible form of incentive compensation that requires minimal administrative costs or time commitment from human resources. There are very few limitations on the amount, timing, performance measures, or number of employees included in the plan. As long as the bonus is a reasonable amount, the employer may deduct the payment when made. The employee will recognize the bonus as taxable income in the year received.

While a cash bonus may be an effective tool for rewarding a key employee, it doesn't provide an incentive to retain their employment beyond the current bonus period. The business owner runs the risk that a skilled, experienced employee may simply use the bonus money to terminate their employment and establish themselves as a competitor.

One common alternative is to pay the contributions into a cash value life insurance policy owned by the employee. Such policies typically have built-in surrender charges in the early years and require ongoing contributions in order to maximize the accumulation values. These features act as a natural vesting schedule.

Restricted Bonus Plans

A restricted bonus plan involves the combination of three separate components: an employment contract, bonus arrangement (discussed above), and a restrictive endorsement.

The employee receives bonuses that are paid into a cash value life insurance policy owned by the employee. The employment contract requires them to pay back the bonuses should they violate the terms of the agreement – for example, if they terminate employment or provide services to another employer. The restrictive endorsement limits their ability to gain access to the insurance policy cash values without the approval of the employer.

When designed properly, the bonus is deductible by the employer when paid and provides sufficient restrictions to motivate the employee to continue their employment.

Select the appropriate strategy (continued)

Nonqualified Deferred Compensation Plans (NQDC)

Qualified retirement plans such as 401(k) plans provide employees an opportunity to defer taxation on their income until retirement.

However, qualified plans limit the amount of income an employee may defer and prohibit the employer from discriminating in favor of highly compensated employees. Nonqualified deferred compensation plans are designed to provide similar tax deferral benefits to key employees without the limitations on the deferral amount and without the participation requirements of qualified plans. They provide the employee an opportunity to defer their salary and/or bonus (up to 100%) until a future date.

In order to avoid many of the burdensome requirements of the Employee Retirement Income Security Act (ERISA), nonqualified plans are actually required to limit participation to a select group of highly compensated employees or management.

From the employer's perspective, contributions are deductible when the compensation is paid out, not when it is deferred.

Supplemental Employee Retirement Plans (SERP)

A SERP is a NQDC (discussed above) in which the employer makes additional contributions.

A SERP may include a vesting schedule that limits the employee's rights to the additional employer contributions for a period of time, providing an incentive for the employee to remain with the company. The amount of the contribution, the length of the vesting schedule, the formula for determining the contribution, and how plan contributions are invested are all at the discretion of the employer with minimal limitations.

Grants of Stock, Restricted Stock, Stock Options

An employer may consider granting key employees an ownership interest in the business. This may be done through a direct grant of stock, restricted stock, or through stock options which give the employee an option to buy an ownership interest.

While granting an ownership interest in the business may be the most direct way to align additional compensation with the success of the business, owners should take into consideration that a minority shareholder or partner may have rights beyond the right to distributions of profits.

These rights are granted by state laws and may include the right to bring lawsuits against officers and directors for wrongful acts against the corporation, the right to inspect corporate books and records, and the right to not be "oppressed" by majority shareholders.

Phantom Stock and Stock Appreciation Rights

An alternative to compensating key employees through direct ownership is to provide a compensation arrangement that mirrors the financial rewards employees receive with direct stock ownership without providing the employee all the associated legal rights of ownership.

Two common plans are phantom stock and stock appreciation rights plans (SARs). Both phantom stock plans and SARs are designed to provide key employees with additional compensation based upon the success of the company (growth in stock value). In order to receive this additional compensation, the employee is typically required to continue employment for a period of time.

A phantom stock plan provides additional compensation based on the value of the employer's stock including appreciation, while a SARs plan provides additional compensation based solely on the appreciation of the employer's stock.

Stay Bonus Plans

Retaining key employees becomes even more critical when a business owner is considering transitioning ownership of the business (via sale or gift). The financial strength of the business post-sale is often an important objective as the sales agreement may contain adjustments to the sale price should the business struggle after the sale.

In addition, when a family business is transferred to a younger generation, the exit of key employees may make for a difficult transition. A stay bonus plan is designed to provide incentive for a select group of key employees to continue their service to the company for a period of time after a change of control occurs. Those who continue their employment receive a cash bonus as long as they continue their employment for the designated time, typically no longer than two or three years.

Since the death of the business owner will trigger a change in control, a cash value life insurance policy on the life of the business owner, owned by the business, may be an effective way to provide the funds necessary to pay the stay bonus obligations. If the change in control is not triggered by the owner's death, policy cash values may be used to pay the bonuses.

Survivor's Income Plans

In a survivor's income plan, the employer commits to paying a stated amount of compensation (often a multiple of their final salary) to a beneficiary designated by a key employee when that employee passes away.

Such agreements typically only pay the stated compensation if the employee was employed by the employer at the time of their death. The employee will not recognize any taxable income during their employment, but the payments will be taxable to their beneficiary when received. Payments made at the time of the employee's death will be deductible by the employer.

Select the appropriate strategy (continued)

Split-Dollar Arrangements

A spilt-dollar arrangement is an agreement between the employer and employee in which they split rights to a life insurance policy's accumulation values and death benefit.

There are a number of different ways to design a split-dollar arrangement, but in general, each involves the employer paying all or a majority of the premiums, retaining a right to recover their premium outlays via policy cash values and death benefits. The employee receives the right to some portion of the cash values (for supplemental retirement income) and death benefit.

A split-dollar agreement may provide a number of tax advantages for the employee, such as minimal annual tax outlay when the premiums are paid, tax-deferred growth of policy accumulation values, income-tax-free loans from the policy, and a tax-free death benefit. While the employer contributions are not deductible, they typically do retain the right to receive all of their premium contributions back.

A word on noncompete agreements

Many business owners look to noncompete agreements as a way to protect intellectual property and trade secrets. The terms of such agreements vary, but generally they limit the employee's ability to provide similar services to other employers during the term of their employment and for a period of time after their employment terminates.

The enforceability of the agreement will largely be dictated by state law. Having key employees sign a noncompete agreement may be a sound business decision, but it has very little value as a retention or motivational tool.

Indexed universal life (IUL) insurance policies provide protection (death benefit), accumulation potential, tax deferral, and flexibility for loans and withdrawals. IUL could also help support your business's key employee compensation strategy.

→ **SCAN THIS QR CODE** for a short video on key compensation ideas.

→ Then contact your **financial professional** to discuss your needs.

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

IUL requires qualification through health and financial underwriting.

The death benefit is generally income-tax-free when passed on to beneficiaries.

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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