Allianz Life Insurance Company of North America

LIFE ADVANCED MARKETS

Survivor's income protection plan

Key employee compensation strategies

> Everyone talks about building a relationship with your customer. I think you build one with your employees first.
>
> – Angela Ahrendts, former Senior Vice President, Apple

There is an unmistakable, growing trend many small-business owners are facing – the difficulty in attracting and retaining qualified employees.

In a 2020 national survey of small-business owners, "finding and keeping skilled employees" ranked 5th out of 75 potential business concerns – jumping from 14th place just four years earlier (and 38th place in 2012). [1, 2, 3]

If you're a business owner, one way to address this concern is to implement an effective key employee compensation plan. A survivor's income protection plan may be an attractive part of such a plan.

Basic design

A survivor's income protection plan is an agreement between an employer and an employee in which the employer agrees to pay the employee's named beneficiary a stated amount should the employee pass away during their employment. This can be in either a lump sum or over a period of years specified in the agreement.

The goal is to protect the employee's family from a loss of income should the employee pass away prior to retirement. The named beneficiary is typically stated in the agreement as a class of individuals (e.g., the employee's spouse or children). The amount payable at the employee's death may be a stated amount or based on a formula (typically a multiple of salary).

[1] National Federation of Independent Business, Small Business Problems & Priorities 2020, Tenth Edition. https://assets.nfib.com/nfibcom/NFIB-Problems-and-Priorities-2020.pdf

[2] National Federation of Independent Business, Small Business Problems & Priorities August 2016. https://www.nfib.com/assets/NFIB-Problems-and-Priorities-2016.pdf

[3] National Federation of Independent Business, Small Business Problems & Priorities 2012. https://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/small-business-problems-priorities-2012-nfib.pdf

An example would be a plan that promises to pay three times the employee's average base pay in the three years preceding death. The agreement may also include a vesting schedule. For example, the agreement may require the employee to have five years of employment with the business in order for the full benefit to be payable.

Note: It may be appropriate for the agreement to limit payments when the cause of death is suicide within the first two years of the agreement (what is commonly referred to as a contestable period). Prior to implementing a plan, employers should seek the advice of qualified legal professionals.

Funding the plan

The business may acquire life insurance on the employee's life to provide the necessary funds to meet their commitment under the plan. The business would be the owner and beneficiary of the life insurance policy and pay premiums. Upon the death of the employee, the business has the option to use the death benefit proceeds from the life insurance policy to make the required payments under the plan, or they may use other funds available to the business at the time.

The employee would not have any rights to the employer-owned life insurance policy and the agreement should clearly state that benefits are not linked to any life insurance policy purchased by the employer. The benefit is solely an obligation of the employer.

A fixed index universal life insurance policy (FIUL) may be an appealing option for a survivor's income protection plan.

As the owner of the FIUL providing the death benefit protection, the business would have access to any available cash value accumulation – which may be used for various business needs – via withdrawals and/or policy loans.[1] The FIUL policy may also be purchased with a death benefit above the amount owed the employee's beneficiary.

This additional life insurance coverage may allow the business to recover a portion of the cost of the plan and/or provide the employer a means to recover any financial loss that results from the loss of the key employee. Finally, should the employee survive their employment years, the employer may retain the FIUL policy and benefit from tax-favored access to policy cash values and/or death benefits.

Advantages

- Provides an attractive benefit to key employees that is simple to communicate.
- Requires minimal administration.
- The employer may limit the plan benefits to selective key employees.
- Death benefits received from an employer-owned life insurance policy are generally received income-tax-free.[2]
- If properly designed, the benefit payable to the employee's beneficiary will not be subject to federal estate taxes. If estate taxes are a concern, participating employees should seek the advice of professional legal and tax advisors.
- Benefit payments made to the employee's named beneficiary are income-tax deductible to the employer as long as they represent reasonable compensation for services the employee rendered.[3]

[1] 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.

[2] An employer-owned life insurance policy is subject to the requirements of Internal Revenue Code 101(j) in order to obtain an income-tax-free death benefit. In general, those rules require that before the policy issued, the employer must provide the insured with a written notice of the life insurance, obtain a written consent from the insured, and provide the IRS with ongoing annual reporting regarding policy ownership. Consult with an attorney for application of those rules to a specific situation.

[3] IRC §162

- The plan does not cause the employee to recognize taxable income during the life of the plan.
- When the plan is funded with an employer-owned FIUL, the employer retains ownership of policy cash values which accumulate on a tax-deferred basis; cash values may be accessed on a tax-favorable basis via withdrawals and/or policy loans.[1]
- The plan is not required to comply with IRC §409A requirements applicable to nonqualified deferred compensation plans.[2]

Considerations

- The employer may not deduct life insurance premium payments when made.
- The benefit is taxable to the employee's named beneficiary.[3] However, Social Security, Medicare, and federal unemployment taxes will not apply to amounts paid on or after the termination of employment due to death.[4]
- Funding the benefit with a life insurance policy covering the life of the employee requires health and financial underwriting.
- There is no guarantee that a policy will earn sufficient interest to support a loan and/or withdrawal strategy.

As business owners face the growing challenge of attracting and retaining key employees, it is important to determine the most efficient way to allocate business resources (both time and money) toward that goal.

Getting to know your employees and what motivates them is an important step. If they're concerned about protecting their families from a loss of income, a survivor's income protection plan could be a valuable benefit to offer.

TALK TO YOUR FINANCIAL PROFESSIONAL

For more information on how an **FIUL policy can support a survivor's income protection plan,** contact your financial professional.

[1] 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.

[2] Treas. Reg. 1.409A-1(a)(5)

[3] IRC §691

[4] See IRS Publication 15-A (2020)

Product and feature availability may vary by state and broker/dealer.

Guarantees are backed solely by the financial strength and claims-paying ability of Allianz Life Insurance Company of North America.

Products are issued by Allianz Life Insurance Company of North America, 5701 Golden Hills Drive, Minneapolis, MN 55416-1297. 800.950.1962. www.allianzlife.com

This notice does not apply in the state of New York.