Allianz Life Insurance Company of North America

LIFE ADVANCED MARKETS

Business continuation bonus plans

Key employee compensation strategies

As a business goes through its startup and growth phases, its ability to recruit and retain employees who have unique skill sets, specific knowledge, and experience in the industry, or who bring valuable relationships to the table, is essential.

And as the business owner looks toward an eventual exit from the business, retaining these key employees may be just as important.

Whether your plan is to sell your business to a third-party buyer or gift the business to family members, there is value in having key employees remain with the company after the transition. One strategy to accomplish this goal is the business continuation bonus plan.

This brochure must be preceded or accompanied by the "Understanding indexed universal life insurance" brochure (M-3959) or the applicable product consumer brochure (M-8119).

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Basic design

A business continuation bonus plan is a form of key employee compensation designed to provide a financial incentive for the employee to continue employment for a predetermined period of time after a change of control occurs.

You (the business owner) and your employee enter into a contractual agreement in which you promise to pay the employee a cash bonus as long as they continue their employment for the designated period of time after a change in control – typically no longer than two to three years. The bonus compensation will be taxable compensation to the employee and deductible for the business.

The business may fund the potential future obligation by purchasing a cash value life insurance policy for the owner – such as indexed universal life – that provides death benefit protection as well as other benefits. The business is the owner and beneficiary of the policy; the business owner is the insured.

If a bonus payment is required during your lifetime, the business may take tax-free loans or withdrawals[1] from any available cash value in the policy to provide the funds needed. Should you pass away, the tax-free death benefit proceeds received by the business may provide the necessary funds.[2]

A change in control may be triggered by a number of different events – such as a gift of a majority ownership interest to family members, a sale to a third-party buyer, or an involuntary transfer caused by your death.

Death of the owner

Upon your death, your business ownership interest will be transferred based on your existing estate plan. If your goal is to have the business continue after your passing, a business continuation bonus plan may provide a financial incentive for key employees to continue performing their duties.

Even if your intention is to have the business and/or its assets liquidated after your death, an effective liquidation may take time and require the expertise of a few of your key employees. Providing an incentive for them to remain until the liquidation is completed will help your family receive a fair market value for the business assets.

Transfers of business ownership to family (sale or gift)

If your goal is to transfer your business to the next generation during your lifetime, it may be valuable for those employees who play a key role to remain with the company as your adult children take over.

The post-transition period is a crucial time for the business and may cause emotional reactions and create concern about new ownership. A business continuation bonus plan may provide an incentive for those employees to continue their employment during the transition.

Sale of business to a third-party buyer

As a business owner, your exit plan may be to sell your business to a non-related third-party buyer. In general, third-party buyers will be one of two types – strategic (or synergistic) buyers or financial buyers.

[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 may be 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 is issued, the employer must provide the insured with a written notice of the life insurance and obtain a written consent from the insured. Consult with an attorney for application of those rules to a specific situation.

Strategic buyers

A strategic buyer may be a business that is in a similar or complementary industry as your business. For example, if your business sells construction equipment, another business that also sells construction equipment and is interested in creating efficiencies and growing their geographic reach may have an interest in acquiring your business. Or a business that manufactures construction equipment may wish to gain more control over the sales aspect of their product and have an interest in acquiring your business.

Strategic buyers may already have industry knowledge and employees with the requisite expertise. As a business owner, you may be concerned that your current employees could be at risk of having their employment terminated when the business is sold to a strategic buyer.

One way to address that concern is to enter into employment contracts with key employees that provide a severance payment for an involuntary termination of employment.[1] In addition, the strategic buyer may also wish to retain key employees for a period of time during the transition. A business continuation bonus plan may be deemed a valuable incentive for key employees to continue their employment after the transition.

Financial buyers

A financial buyer simply has dollars to invest and sees your business as an opportunity to achieve attractive returns. These buyers may take the form of private equity firms, venture capitalists, or other similar investment firms.

Financial buyers may be concerned that a change in control of the business may cause key employees to terminate their employment. Since the financial buyer does not bring specific industry knowledge and skill sets regarding the day-to-day operations of the business, the loss of a key employee could have a negative impact on business profits. A business continuation bonus plan may be viewed as a valuable key employee retention incentive for the buyer.

Regardless of the type of third-party buyer, your goal will be to maximize the value of your business prior to a sale. The buyer will analyze your business financials and do a comprehensive due diligence review of existing contracts, real estate titles, potential litigation exposure, qualified plan compliance, etc. They will also want to evaluate the strength and skill sets of your employees, and specifically, key employees. Having an incentive plan in place to retain these employees may allow the seller to negotiate a higher sale price.

For information on the tax implications of this strategy, consult your tax advisor or attorney. And for information on how indexed universal life insurance could support a business continuation bonus plan, contact your financial professional.

Life insurance qualification is subject to health and financial underwriting.

[1] In order to avoid application of IRC §409A as deferred compensation the severance plan must meet one of the exceptions under the §409A final regulations. One exemption is for involuntary separation from service under Treas. Reg. 1.409A-1(b)(9)(iii). Under this exemption the severance compensation may not exceed two times the lesser of (a) the individual's annual compensation for the preceding calendar year, and (b) the tax-qualified plan compensation limit (2 x $290,000, or $580,000, for 2021), and must be paid no later than December 31 of the second calendar year following the year of termination.