

Using Life Insurance to Retain Key Employees and Protect the Small Business

Authored By: Heather L. Schreiber, RICP®

While most financial professionals routinely work with individual clients and couples, you likely have small business clients as well. The needs of a business are unique; your ability to identify strategies to enhance the goals of business clients can lead you to referrals for the owner or employees' individual planning needs.

At the heart of a successful business is its employees. Attracting, retaining, and rewarding employees while also protecting the needs of the business are all critical to remain competitive as an employer. Benefits including healthcare coverage, employer-sponsored retirement plans, and paid time off are often the foundation of most employee benefit packages.

But what about key employees – the ones that the business relies on and whose unanticipated departure could throw an untimely wrench in the cog wheel? Investing in an executive benefits program can be less costly than having to re-invest in the recruitment and training of a replacement for a key employee who jumps ship unexpectedly or dies. Creating an executive benefits package that leverages life insurance can often make the financial outlay more affordable while checking the box on more than one goal of the employer.

401(k)s Can Fall Short

While the benchmark of a retirement benefits package is the 401(k) for most employers, these plans are governed under the Employee Retirement Income Security Act (ERISA). This means that a 401(k) plan must be offered to all employees of a company once the eligibility

requirements are satisfied. Highly compensated executive level employees are often limited in the amount they can contribute to a 401(k) due to the discrimination testing involved in such plans. For these employees, the dazzle of maxing out a qualified retirement plan may lose its luster if handcuffed by complex contribution formulas that can reduce their ability to save as much as lower paid employees. Even if a key employee can take maximum advantage of the plan's contribution limits, that benefit alone may not be enough to attract or retain a highly compensated employee who is looking for enhanced opportunities to save for retirement.

Non-Qualified Arrangements to the Rescue

Executive compensation packages, or non-qualified arrangements, can pick up where a 401(k) or similar qualified plan falls short for key employees. Here is why. Non-qualified plans are engineered to discriminate in favor of key employees and directors. In fact, the Department of Labor requires that the non-qualified plan be designed to cover only a select group of employees¹. They are not subject to the same regulatory compliance issues as qualified plans and can bridge the gap in a retirement benefits package for C-level officers and other critical employees.

The use of life insurance in attracting and retaining key employees and to protect the business from a key employee's departure or death is a leveraging strategy that can serve more than one purpose. Life insurance can provide income replacement to the key employee's family in the event of his/her

death, but it can also be used to fund retirement on a tax-preferred basis. From the employer's perspective, life insurance may also be used to protect the business owner from the departure or death of a key employee.

Most employers offer group term life insurance, but employer-provided term insurance is generally only in effect while the employee is employed and is limited in scope and amount; some employers allow an employee to purchase additional amounts of coverage but often the policy is not portable, nor can it scratch the surface of what a highly compensated employee really needs.

Section 162 Executive Bonus Plans

Section 162 executive bonus plans can be a relatively easy solution offered to a select group of key employees to both supplement group life insurance and as a retention tool. The employer gives the key employee a bonus, and the bonus can be used to pay the premium on a cash value life insurance policy. The employee owns the policy and names the beneficiary. Because the bonus to fund the policy is considered compensation and the employer has no interest or ownership in the policy, the employer gets a tax deduction for the bonus used to fund the policy². Some employers elect to gross up the bonus to cover the anticipated tax liability on the additional compensation.

The benefits of using a Section 162 bonus plan to attract and retain key employers include:

1. Ease of administration and set up
2. Employer's ability to deduct the bonus as compensation to the key employee
3. It's not governed by the compliance rules associated with qualified retirement benefits under ERISA
4. Complete control by the key employee

5. It may be used as supplemental retirement income in addition to the protection of the key employee's family through the death benefit.

Supplemental Executive Retirement Plan (SERP)

A SERP is another type of non-qualified deferred compensation plan used to attract and retain key employees. Unlike a 162 Bonus plan, the SERP is an agreement to pay a key employee at a future date, usually retirement, provided they meet certain criteria like agreeing to stay on board until a certain date or meeting certain performance metrics. The plan can be either funded or non-funded.

A funded plan is one in which the employer sets aside the funds to pay the future benefits inside an irrevocable trust, often referred to as a "rabbi trust". In this case, because the money is set aside for the employee, immediate taxation to the employee is generally the result and the plan must comply with many of the regulations under ERISA.

An unfunded SERP is one in which the key employee has no rights to the funds of the employer, the funds are not segregated from general assets, and the deferred amounts are subject to the general claims of the employer's creditors. Because the unfunded SERP, the more common arrangement of the two, is an agreement to pay the benefit in the future and has a risk of forfeiture, the employee is not taxed on the income nor are the funds deductible by the employer until the key employee vests by satisfying the agreed-upon terms to receive the income.

Employers can use a variety of investments to fund future promised benefits including a life insurance policy; the benefit of using a life insurance policy over securities is that the employer avoids having to pay taxes on the investment gains. Generally, the company will purchase a policy sufficient to pay out the agreed-upon future benefits. The employer both owns and

is the beneficiary of the policy. The employer can use the cash value of the policy at any time. Once the employee meets the vesting requirements, the employee is taxed on the income as it is received, and the employer takes the corresponding deduction. If the key employee dies, the tax-free death benefit may be used by the employer to replace or recover the plan costs or to pay the key employee's family a death benefit³.

Split Dollar Arrangements

Split dollar life insurance is a strategy whereby the employer and employee may share in the cost of the insurance for the key employee or the employer pays entirely for the policy with certain agreed-upon conditions. From the employer's perspective, the arrangement is used as a retention tool for a valued employee; from the key employee's vantage point, the arrangement generally costs less than if the employee purchases his/her own personal life insurance policy. The arrangement requires the execution of an agreement between the employer and the employee that outlines such things as who will own the policy and how the premium costs, future cash value, and the death benefit will be split. The agreement also outlines what will terminate the agreement, such as the termination of the key employee, their death or at another agreed upon time⁴.

Ownership Structure

Under a collateral assignment method, the key employee or a third party owns the policy and the employee collaterally assigns certain agreed-upon rights to the policy back to the employer.

If the plan is structured under an endorsement method, the employer owns the policy and the rights to the policy under the split dollar arrangement are contained in an endorsement filed with the insurance company. The key

employee is taxed annually on the economic benefit, or value of the life insurance provided, using IRS Tables.

Key Person Insurance

The strategies covered so far have been those that focus primarily on attracting and retaining certain key employees to the business. Key person insurance, on the other hand, is designed to protect the business from the death of a key employee, or one whose skill, knowledge, or experience would be difficult to replace and whose performance is critical to the success of the business.

Key person insurance is owned by and premiums paid by the company. In a small business, the owner may be the insured. The insured employee must agree upon the purchase of the policy on his/her life. In the event of the death of the insured, the business may use the death benefit to recruit, hire, or train a suitable replacement or to pay off the debts of the company if the key employee's death will cause the business to close. Premiums paid by the employer for key person insurance are not tax deductible to the business because the company receives a future economic benefit in the death benefit⁵.

Uncovering Opportunities

Meeting with business clients affords you the opportunity to ask questions to uncover the goals as well as the challenges they face. Gain understanding of how the business operates, the owner's philosophy on making the business successful and profitable, and who the most instrumental employees are. Knowing the answers to these questions can naturally lead to conversations about the viability of executive benefit arrangements to protect and grow the company, but also to attract and retain the best talent.

Sources

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