No Better Time To Sell
Executive Benefits
Key employees are many businesses’ most valuable assets. This is a great time to talk with business owners about life insurance-funded executive benefits for their key employees. Why? Three recent developments may show owners how tenuous their hold on their key employees may be. Owners who understand these developments will be more open to establishing executive benefits plans for their key employees.
The three developments are:

1. **Expanding Opportunities**

   Experts say the US economy has been growing steadily over the last two years and the job market is expanding. According to the Bureau of Labor Statistics the number of available jobs (which plummeted to under 2.2 million in July 2009) has averaged nearly 3.8 million since the beginning of 2013. Job growth usually translates into more (and often better) employment opportunities for top workers.

   “The ‘quit rate’—the percentage of American workers who leave their jobs voluntarily—has risen to the highest level in four years. That shows that workers are more confident about finding new jobs. When people change jobs, they usually change to better jobs and change to higher-paying jobs.” says Sophia Koropeckyj, an economist with Moody’s Economy.com.¹

   In May, 2013 the national employment consulting firm OI Partners released a survey which reported that more than half of the 153 organizations surveyed have experienced higher turnover than last year; three quarters of these organizations are bracing for still more employees to leave.² This turnover involved all organizational levels, including middle managers and senior-level executives.

   Some owners may think “that won’t happen to us. Our key employees are loyal and committed.” They might be wise to think again because it’s easy to take employee loyalty for granted. MetLife’s 11th Annual Study of Employee Benefits Trends finds that many business owners overestimate the loyalty of their employees: “Many employers are not attuned to how their employees really feel on the loyalty front. Although nearly two-thirds (64%) of employers claim to be very loyal to employees, only 35% of their employees actually perceive this loyalty. Employers should be cognizant and cautious of this loyalty gap.”³

2. **Tax Law Changes**

   In January of 2013 Congress passed the American Taxpayer Relief Act (ATRA). Most Americans won’t see their income taxes increase under this new legislation. Some business owners and key employees, however, will experience higher taxes on their work-based compensation. Among other changes, ATRA added a new federal income tax bracket of 39.6% for high income taxpayers (singles exceeding $400,000 and married couples filing jointly in excess of $450,000) and increased tax rates on capital gains and dividends to 20% for these high income taxpayers. The Patient Protection and Affordable Care Act (aka “Obamacare”) placed an additional 3.8% tax on some of the investment earnings of high income taxpayers. As a result of these and other tax law changes, some high income key employees are frustrated. They may be interested in executive benefits that have the potential to reduce their overall tax burden. Businesses that can help them maximize their after-tax income may gain their attention and loyalty.

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¹ “Job Turnover Increases In A Recovering Market,” by Lorraine Mirabella, The Baltimore Sun, June 22, 2013, Baltimoresun.com

² OI Partners 2013 Retention Survey Report

³ Met Life 11th Annual Study of Employee Benefits Trends, Executive Summary
3. The New Health Insurance Rules

A new era in health insurance is beginning. People are using the new health insurance exchanges created under the Patient Protection and Affordable Care Act. In the past, one of the best and most realistic ways for people to get health insurance was by working for an employer that offered health insurance benefits. After 2013, nearly everyone will have access to health insurance regardless whether they are employed or who their employer is. The Act makes health insurance available through state or federally administered exchanges and does away with individually underwritten policies that had the potential for being declined, limited due to pre-existing conditions or priced at unaffordable levels. The transition to the new health care rules will probably be confusing and messy. But, at the end of the day, health insurance will be available to everyone. Health insurance will no longer be a benefit that can be used as a recruiting and retention tool.

The new health insurance rules potentially make it easier for five types of key employees to change jobs:

- Those who want new experiences, new colleagues and new responsibilities.
- Those who want to work at smaller, more focused companies that haven’t previously offered employee health insurance benefits.
- Those over age 60 who are considering retirement and don’t want to lose access to health coverage. They may purchase coverage through an exchange and don’t need to wait until they become eligible for Medicare at age 65.
- Those who want to start their own businesses.
- Those who have been “stuck” with an employer because their spouse/partner hasn’t had access to health insurance coverage.

The bottom line is that the new health insurance rules reduce a business’ ability to retain its key employees. Employees will have more freedom and flexibility in their job decisions, including changing jobs, retiring or starting their own businesses. Health insurance coverage will be much less important to them in deciding where and how long to work.

Who Can’t the Business Afford to Lose?

Employee turnover happens in every business. What’s important is to limit turnover to the right people. That’s because from a profitability perspective, some employees are more valuable than others. Business owners should consider reviewing their personnel and identifying employees with the special skills, knowledge or relationships that impact business performance and value. If any of these key people leave, the business could be negatively impacted in three potential ways:

1. **Reduced Revenues.**
   
   Replacing key people can be expensive. A recruiter may have to be hired. Suitable replacements may command a higher salary and a more comprehensive benefit package. Because of the nature of the job or the business, extensive training could be needed. It will likely take some time before the replacement can perform as well as the original key employee.

2. **Increased Expenses.**
   
   Key employees often have strong relationships with clients. When they do, key employees may take clients with them when they leave. The loss of good clients can be disastrous. Attracting new ones can be expensive and time-consuming.
Carrots And Sticks

A carrot and stick approach could potentially keep key employees from looking for greener pastures. “Carrots” are strategies designed to motivate them, increase loyalty and make them happy. “Sticks” are strategies designed to make leaving more difficult and to make key employees less attractive to other companies. A strategy for retaining key employees should include both.

Carrot strategies include: (1) formal recognition of the key employee’s contributions and sacrifices for the business, (2) a heartfelt “thank you” for their service to date, (3) a tangible reward for their efforts, and (4) new financial incentives to continue their high performance in the coming years.

A life insurance-funded executive benefit could potentially provide all four of these carrots. It could provide the recognition necessary to keep the key employees on board and committed for the coming years. Executive benefits such as a Self Owned Life And Retirement (S.O.L.A.R.) Insurance Arrangement, a Section 162 bonus plan, REBA (restricted executive bonus arrangement), split dollar loan, 401(k) Look-Alike plan, or a non-qualified deferred compensation plan/supplemental executive retirement plan (NQDC/SERP) could be customized for each key employee. As they remain productive and feel appreciated, their skills could produce the revenues needed to pay the costs of the benefit.

Three Reasons to Use Life Insurance

Life insurance policies have several unique features which may be quite useful in customizing executive benefits. For example:

1. When the plan includes a death benefit, life insurance has the potential to immediately fund this obligation by matching the policy’s death benefit to the promised benefits. The policy will pay out a death benefit if the key employee dies before the promised benefits are due to be paid (assuming the policy is still in force).

2. When the plan promises to pay a key employee supplemental retirement income, life insurance cash values may provide the business a potential source of funds from which to make the promised payments. If the policy is not a modified endowment contract (MEC), the business may generally access policy cash values on an income tax-deferred basis.*

3. Life insurance policy death benefits are generally paid out income tax free and, if properly structured, may allow the business to recover some or all of the costs it incurred to provide the benefit.**

* Policy loans and partial withdrawals may vary by state, reduce available surrender value and death benefits, or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to the cost basis (usually premiums paid), followed by policy loans but only if the policy qualifies as life insurance, and is not a modified endowment contract.

** For policies issues after August 17, 2006 IRC 101(j) provides that death benefits from an “employer-owned life insurance policy” are income taxable in excess of premiums paid, unless an exception applies and certain notice and consent requirements are met before the policy is issued. Additionally, life insurance owned by a C corporation may subject the corporation to the alternative minimum tax.
Executive Benefit Ladders

Life insurance-funded executive benefits may also be structured as a related series. The benefits can be designed to build on each other over time to provide increasing incentives to participating key employees. Such arrangements are known as executive benefit ladders, and they may be attractive to businesses because the costs can start small and increase as business cash flow permits. Also, the benefit has the potential to be changed over time and become more valuable the longer the key employee stays with the business. In fact, increases in the key employee’s productivity could possibly produce the revenues needed to pay for the benefits.

Sticks

Sticks are strategies that force a key employee to pay a “price” if he/she leaves the business prematurely. An example is a restriction in a 162 bonus arrangement that prevents the key employee from accessing life insurance policy cash values without the written consent of the employer. This restriction converts the arrangement into a REBA (restricted bonus arrangement). Another commonly used restriction is a provision in an employment agreement which requires the key employee to repay bonuses received if he/she leaves the business prior to a specified date or before retirement.

Another useful stick is a non-compete agreement. This is an agreement (or part of an employment agreement) in which the key employee agrees not to solicit the business’ clients for a specified length of time (usually not longer than one year) and within a specific geographic area. A non-compete agreement helps the business protect its client base and puts employees on notice that they won’t be able to just walk out the door with the business’ client list. Non-compete agreements may also be effective in retaining key employees because their inability to take customers with them may decrease their value to competitors.

Linking the executive benefit and the non-compete agreement could potentially provide the best of both worlds.

Non-compete agreements are not a “do-it-yourself project." Because the rules for these agreements vary from state to state, a knowledgeable attorney should be engaged to draft the agreement. Some states have laws that prevent the enforcement of non-compete agreements unless the employee receives something of value (consideration) in return for making the non-compete promise. A life insurance-funded executive benefit created as a carrot may provide the valuable consideration needed to satisfy these state law requirements.

Linking the executive benefit and the non-compete agreement could potentially provide the best of both worlds. The executive benefit can provide recognition for the employee’s efforts, incentive to continue top-notch performance, and the value needed to make the non-compete agreement enforceable (assuming the agreement is drafted to comply with all applicable state laws).
Conclusion

Business owners forever find themselves with new problems and opportunities. A problem they can’t afford to overlook is the loss of any of their key employees. The expanding job market and the separation of health insurance coverage from employment status may make it more difficult for businesses to retain key employees and motivate them to do their best. Life insurance-funded executive benefits can be customized to create incentives for key employees to stay and become even more productive. As the economy continues to grow, cash value life insurance has the potential to help business owners lock in their key employees and grow their businesses.