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CREATIVE STRATEGIES TO RETAIN KEY EMPLOYEES

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Key employees make money for their employers, and they often know it. They also know that their skillset is portable - those skills, connections, relationships, and knowledge can be taken to the open market and sold to the highest bidder. Traditionally, key people identify with and have a strong commitment to their organization, but if they feel underappreciated, they may take their mojo elsewhere. Problematically, there are significant barriers to compensating them in a tax favored way. Increase their pay, and their tax rate increases. If you increase their retirement plan contribution, then the entire 401k plan could fail the discrimination testing. If you try to bonus them up to fund their retirement, they could quickly exceed the IRS limits. Providing ownership opportunities creates a completely new set of complexities. However, there is one other option that exists that does not run the risk of driving your key employees away: an executive benefits plan to put on the "golden handcuffs."

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IRS Code Section 162

The Internal Revenue Code has long favored life insurance contracts and code section 162 deals specifically with these policies that support compensating key employees. The way it works is surprisingly simple:

- The employer pays for a life insurance policy for a key person, or group of key people. It is very flexible and allows for compensation-based discrimination.
- The key person is provided life insurance. If that key person dies, their estate receives the life death benefit tax-free.
- The employer pays more for the policy than the actual cost of the insurance. This extra funding is put into an account, allowing "cash value" to accrue. Cash value is what it sounds like - money sitting in an account.
- Usually set up with a "restricted endorsement," the employee will have the life insurance from day one, but cannot touch the cash in the account until they have worked for the company for a predetermined period of time, hence the more colloquial name of these types of plans: "golden handcuffs."

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- If the employee leaves the company before the predetermined period of time, they forfeit the cash in the account back to the employer.
- After the specified time period is passed, the employee, whether still with the employer or not, can access the cash in the account via loans. These loans are not considered income, so there is no tax on accessing the cash.

The language and terms within life insurance planning are unique and take some getting used to, but once you become familiar with terminology, these plans are simple to design, simple to execute, and maybe most importantly, simple to explain. Convincing a key employee to stay with an organization using a traditional compensation approach (i.e. one that relies on promises of future investments, roles, or opportunities) can be challenging, especially if those promises have not panned out in the past. Explaining to a key employee that a life insurance-based pot of gold is awaiting them after a handful of years of service is entirely different.

Tax Considerations

There are numerous tax nuances that need to be understood. For example, the employee would owe taxes on any contributions into the policy, so typically the employer pays for both the policy and the tax liability. Additionally, the life insurance component of the plan has a cost. If the employee in question does not have a favorable health history, those insurance costs would be higher. Finally, any cash value would need to be invested in an appropriate manner and the carriers of these plans have very different investment options.

Ultimately, if attracting and retaining key employees is a concern, evaluating a 162 plan against the other options makes a ton of sense. If you are interested in learning more about these types of plans, call an experienced employee benefits consultant for more information.