Executive Benefits

The Retention or "Stay" Bonus for Key Employees

As a business owner, you understand that a key employee can be critical to your success. A key employee's knowledge, experience, and unique skills may be the driving force behind your company's success. Profitability may decline if a key employee left, especially during a transition period triggered by an owner's death or disability. How will you create an incentive for a key employee to stay during a period of change?

Retaining key employees is very important because they tend to posses: (1) unique skills, experience, and leadership; (2) valuable relationships with key clients and centers of influence; and (3) specialized training that makes them difficult, time consuming and expensive to replace. Key employees may be even more critical during a period of change by an owner's death, disability, or retirement. This may be especially true if a successor owner, such as the departing owner's child, has not been very involved in the business and needs guidance that the departing owner may no longer be able to provide. During this uncertain time, a key employee can assist a new owner to effectively transition and improve the company's chances of future success.

Business owners should not underestimate the possibility of a key employee leaving upon an owner's unexpected death or disability because the sudden change in ownership and/or management may cause the employee to feel uneasy and seek another job with a competitor. Owners also should not underestimate the negative impact a key employee's departure may cause on other employees and the business overall.

A retention or "stay" bonus for a key employee can be an effective tool in overall succession planning. In a retention bonus arrangement, the business agrees to pay the employee a bonus if the employee stays for an agreed upon period after a triggering event, such as the retirement, disability, or death of an owner. The employee will have more incentive to stay until the end of the period because otherwise the employee will forfeit the bonus. The owner(s) and employee(s) can negotiate the bonus amount and the stay period. For example, a bonus amount can be a set dollar amount ($100,000) or some multiple of salary (2 times salary). The retention period can be one or two years, or some other timeframe. Alternatively, a business can pay a retention bonus with equity instead of cash, particularly if the key employee will be a successor owner under a buy-sell arrangement.

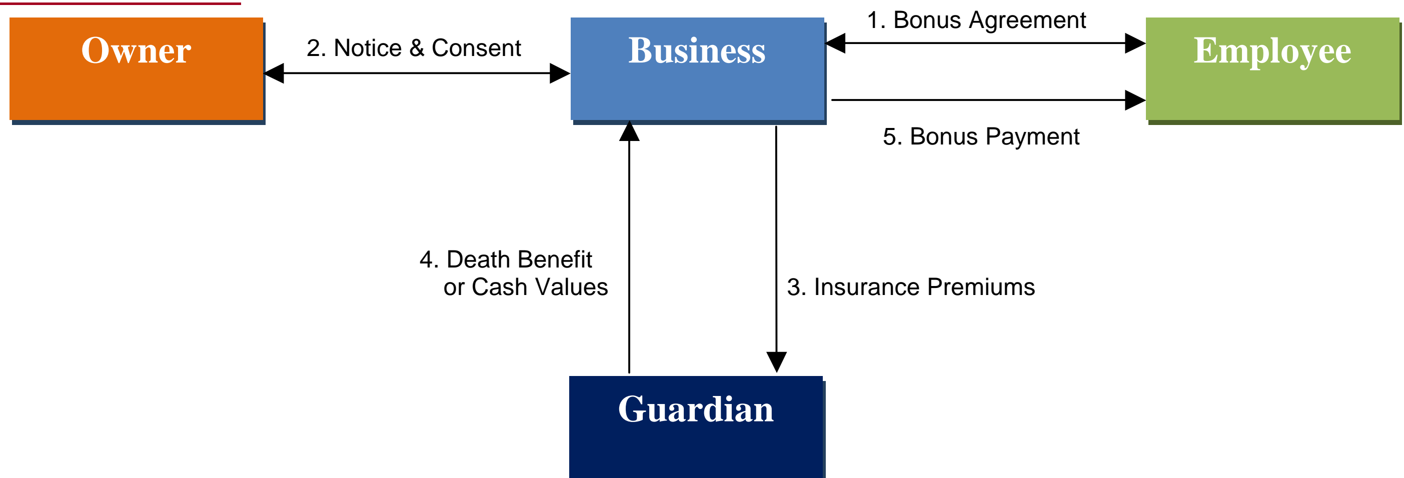
The bonus is generally paid within 2 ½ months after the close of the company's tax-year in which the employee is required to stay. Once the employee fulfills his obligation by staying with the company for the requisite period, the employee is generally vested in his or her bonus. The company will be able to deduct the bonus as compensation, as long as it is reasonable, and the employee will receive taxable income in the year of payment. Payment within 2 ½ months of the company's tax-year is important, otherwise the agreement may be considered a nonqualified deferred compensation agreement subject to stringent rules and regulations, which could cause unfavorable tax consequences if certain requirements are not met.[1] The time period fits within the "short-term deferral" exception period of IRC § 409A which governs nonqualified deferred compensation arrangements.

Executive Benefits

The retention bonus can be informally funded by the business through a permanent life insurance policy on the business owner's life. The company is the owner and beneficiary of the policy.[2] Upon the owner's death, the death benefit may be used for various business purposes including paying the retention bonus. Upon an owner's retirement, disability, or other lifetime departure, the cash values of the permanent policy can be used to pay the bonus.

The business may also use the cash values of a permanent life insurance policy on the life of the key employee to pay the retention bonus. A business may choose to use a key employee policy to: (1) informally fund a nonqualified deferred compensation agreement; (2) help cover expenses and/or lost revenue upon a key employee's death; and (3) informally fund a retention bonus.

How Does It Work?



1. The business and key employee enter into an agreement where the business agrees to pay a bonus if the employee stays for a specified period after a triggering event.
2. The business provides the owner-insured with proper notice and obtains the owner's consent to take out a life insurance policy on his/her life.
3. The business may informally fund the future bonus obligation with life insurance. The business is the applicant, owner, beneficiary, and premium payer of a life insurance policy on the owner's life.
4. Upon the owner's death, the business receives the death benefit income tax-free.
5. If the employee stays throughout the specified period, the business pays the employee a lump sum bonus within 2 ½ months after the close of the tax year in which the employee must stay (e.g., if the agreement requires the employee to stay for two years after an owner's death and the owner dies on October 31, 2012, the employee must stay until November 1, 2014, and the business must pay the bonus by March 15, 2015, assuming the business's tax year ends on December 31).

Advantages

- Flexibility to decide which employee(s) should be offered a retention bonus.
- Ability to retain key employee(s) during a transition period.

Executive Benefits

- Business has access to the cash values of a permanent life insurance policy.[3]
- One business owned policy insuring an owner's life may be used to informally fund a retention bonus and fund an entity redemption plan (e.g., part of the death benefit or cash value may be used to pay the employee's bonus and the remainder may be used to redeem the deceased owner's interest).
- One business owned key employee policy may be used to informally fund a retention bonus and a deferred compensation agreement. The retention bonus and deferred compensation agreements are separate arrangements.

Tax Considerations

- Life insurance premiums are not tax-deductible by the business.
- The bonus is tax-deductible by the business when paid as long as the employee's total compensation is reasonable. The bonus would be taxable income to the employee.
- The death benefit is received income tax-free by the business provided the employer owned life insurance rules are met. For C corporations, the death benefit received, as well as the annual increases in cash values that exceed premiums paid, may be subject to alternative minimum tax.
- For pass-through entities, such as partnerships, limited liability companies, and S corporations, the death benefit received increases an owner's basis in his/her business interest. Premium payments and policy cash values may also affect an owner's basis.

[1] If IRC § 409A requirements are not complied with, which include having a formalized written plan, the employee may have to recognize all of the deferred compensation whether received or not as taxable ordinary income, in addition to paying a 20% excise tax and interest in the year there is noncompliance.

[2] The notice and consent requirements for employer owned life insurance, set forth in IRC § 101(j), should be followed prior to the policy being issued so that the death benefit is not subject to income tax.

[3] Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses or is surrendered, any loans considered to be gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first subject to ordinary income taxes. If the policy owner is under 59 ½, any taxable withdrawal is also subject to a 10% penalty tax.

The foregoing information regarding estate, charitable and/or business planning techniques is not intended to be tax, legal or investment advice and is provided for general educational purposes only. Neither Guardian, nor its subsidiaries, agents or employees provide tax or legal advice. You should consult with your tax and legal advisor regarding your individual situation.

Lanny D. Levin, CLU, ChFC
LANNY D. LEVIN AGENCY, Inc.
1751 Lake Cook Road suite 350
Deerfield, IL 60015
(847) 597-2444
lanny_Levin@levinagency.com

GEAR # 2012-9080 Expiration: 12/31/2015
Guardian Financial Representatives may call the Business Resource Center for Advanced Markets, at 1.800.871.7780, Option 3, for additional information.
GUARDIAN® and the GUARDIAN G® Logo are registered service marks of The Guardian Life Insurance Company of America and are used with express permission.

The Guardian Life Insurance Company of America, 7 Hanover Square, New York, NY 10004