



Locking In Talent When Times Are Tough

By [STEPHEN PIONTEK](#)
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Plunging home prices ... severe credit squeeze ... cascading failures in the financial markets. Advisors who cater to small businesses might rightfully question whether the increasingly grim economic news of recent months will bring pain to their own practices.

That's not likely. Such fears, say market-watchers, are misplaced because demand for life insurance-funded small business plans remains largely immune to economic swings. Yes, distressed businesses may slow funding of these plans to satisfy short-term cash flow needs when in a financial pinch. But the case for or against implementing a plan generally will rest on considerations unrelated to the business cycle. This is especially true of the market for compensation packages designed to attract and retain top-tier executive talent.

"Rarely will year-over-year cash flow considerations cause a business not to implement an executive benefits plan," says Terry Altman, a certified financial planner and president of Altman Group, Bloomfield Hills, Mich. "If I have enough execs for whom I think it's necessary to compete in an open marketplace, then I'll do what's necessary to make sure they're not hired away by competitors. The existing or non-existence of a recession will not be controlling."

Roey Diefendorf, a chief life underwriter and principal of Diefendorf Capital Planning Associates, Locust Valley, N.Y., agrees. "What kills business productivity is turnover," he says. "Especially during economic downturns, you want to limit executive flight using some type of golden handcuffs."

These sentiments are echoed by others interviewed by National Underwriter, who variously report "good" to "substantial increases" in sales during the past year for life insurance-funded small business plans. Chief among these are executive compensation benefits, notably non-qualified deferred comp and IRC Section 162 bonus arrangements. The positive assessments extend also to key person insurance and succession planning, wherein life insurance is commonly used to fund buy-sell agreements and estate equalization among inheritors to a family business.

Sources declined to project revenues from small business life sales in 2008. But most observe that market penetration for such plans continue to rise, particularly among businesses with 100 or fewer employees.

Among larger companies like the Fortune 1000, the trend line has been on the upswing for several years running for non-qualified deferred compensation plans.

A 2007 survey by Clark Consulting, Chicago, Ill., shows the adoption rate of NQDC plans to be at highest since the survey's inception in 1993. Of the approximately 180 companies polled, 95% reported having an NQDC plan, compared to 91% in 2005. Similarly, 72% of respondents who informally fund their NQDC plans choose employer-owned life insurance (EOLI) as the funding vehicle, up from 70% in 2005.

Fueling rising interest in life insurance-funded plans at small businesses are changing demographics. Steve Parrish, a second vice president, life and health, at Principal Financial Group, Des Moines, Iowa, says more affluent boomers are "hitting their peak"—both in terms of financial needs and their ability to fund those needs—as they transition from the accumulation to the distribution phase of their life planning. And so life insurance becomes an attractive vehicle to fulfill retirement, estate or succession planning objectives.

"We think the demographics will be in our favor during the coming years as our advisors reach out to small businesses," says Parrish. "As to the current economics situation, financial products, particularly insurance products, generally don't correlate either way to booms or busts."

When in the minority of cases they do correlate, the relationship might actually be an inverse one. Parrish points to employee stock ownership plans, which business owners may adopt as an exit plan in the event they are unable to sell their company to an outside party. That can happen when prospective buyers are unable to secure financing for an acquisition or fail to show interest in a buyout because of depressed market conditions.

During economic downturns, observers say, the question to be answered by business owners who are keen to offer financial incentives to recruit and retain top talent is not whether to offer an executive comp package, but rather how aggressively to fund one. Those firms that are profitably run and cash-rich should have little problem funding policies to the maximum limit. But those that are experiencing cash flow challenges may deem it prudent—or necessary—to cut back on premium payments until their financial situation improves, at which time they can ramp premiums up again.

Hence the value of flexible funding, and of universal life and variable universal life policies, which allow policyholders to vary payments as conditions warrant. To be sure, sources caution, minimum funding (or under-funding) of contracts can cause them to lapse because of dangerously low cash values. But business owners can guard against this eventuality by purchasing policies carrying a secondary guarantee.

Another option for the cash-strapped firm is to substitute term insurance for permanent insurance, which (depending on the insured's age) is generally more expensive in the early years of the contract. By buying term, businesses can free up much-needed money to meet other financial priorities.

The better option may be to purchase term insurance that can be converted to a permanent policy when the company's cash flow situation is strong enough to sustain

the higher premium payments. Permanent insurance is to be favored, observers say, not only because it allows for leveled premiums (and thus predictable cash flow outlays) over the long-term, but also because cash values accruing inside the contracts grow tax-deferred, an advantage not available with other investment vehicles, such as mutual funds.

What is more, the cash values can be accessed through policy loans and withdrawals, a resource that can prove critical to the business during a financial squeeze.

“[Permanent] life insurance can be particularly valuable as a sinking fund,” says Janice Forgays, a senior vice president at Sun Life Financial, Wellesley Hills, Mass. “Businesses can tap cash values without having to liquidate and pay capital gains tax on the sale of stock or other asset. So the policy serves an important function outside the executive comp plan.”

All well and good. But with many permanent policies, cash values accumulate little—if at all—during the initial years of the contract, a fact that may dissuade some cash-conscious businesses from buying into a plan. To counter this potential deal-breaker, Sun Life unveiled last September two products to fund non-qualified executive benefit plans: Sun Executive Variable Universal Life and Sun Executive Universal Life. The two products, says Forgays, offer high early cash value accumulation (102% of the premium payment during the first year of the contract), plus zero net loans and flexible underwriting options, including guaranteed-issue to benefit both owners and employees.

“Without early cash values in the product, there will be a net deficit on the balance sheet,” says Forgays. “From an accounting standpoint, that can be quite devastating for the small business owner. “So this piece is critical in product design. And product design is absolutely critical to the success of the plan.”

For some businesses, the key issue is not a policy’s impact on the bottom line, but the effect of employee turnover on the policy. Marvin Feldman, president of Feldman Financial Group, Clearwater, Fla., and the president and CEO of the Life and Health Insurance Foundation for Education, Arlington, Va., observes that key person insurance, which is purchased to ensure a business against financial loss due to an executive’s death, may prove of little value if the executive leaves the firm. To protect against this outcome, the business can add an insurance exchange rider, enabling the firm to switch coverage to the executive’s replacement once insurability for the new employee has been established.

Such innovative features in policy design, sources say, are valuable tools with which to ease the plan sale in good times and bad. What might complicate the sale—indeed, make it all but impossible—is not so much the gloomy economic outlook, but the growing number of IRS restrictions on plan design.

Altman points, for example, to an IRS rule (Notice 2007-83) imposed last September on 419(e) welfare benefit plans, which provide executives with a pre-retirement death benefit and post-retirement medical benefit. While the plans are still allowed, businesses can no longer deduct premiums paid on cash value policies used to fund the plans. The notice additionally treats policies placed in trust as listed transactions. Because of the new rule, Altman no longer sell the plans.

“The current regulations are so severe, that that market is essentially gone,” he says. “It appears the IRS wanted to ensure that permanent life insurance is never used in a 419(e) trust, even if the trust is fully compliant with the intent of Congress. I think that’s an unfair thing to do. What difference does it make what you fund the trust with?”

IRS regulations issued since 2003, he adds, have also made less attractive, if not quite killed, split-dollar plans: arrangements in which the employer and employee divide between them policy premiums and benefits according to a predetermined formula and written agreement. The most recent of the new rules, IRS Notice 2007-34, treats the plans as deferred compensation—and thus subject to interest and tax penalties for running afoul of 409A regs governing deferred comp—if amounts on a split-dollar loan are waived, cancelled or forgiven.

Market-watchers ascribe the fading fortunes of another once-promising executive benefits package, the 412(i) defined benefit plan, not to the IRS, but to whims of the marketplace. While offering unmatched features to business owners and execs looking to build up a nest egg fast—tax-deductible contributions exceeding 25% of compensation, exemption from the complex funding rules that apply to all other DB plans and a contribution limit of \$210,000—412(i) is not for the faint-of-heart. The reason: Those who adopt the plan must make the same hefty contributions for at least 5 years and for all employees.

Says Parrish: “Many companies are pulling their 412(i) products—we pulled ours in December—because they don’t want to have to deposit, say, \$100,000 annually into a defined benefit plan. They’re telling advisors, ‘I don’t want to commit that much money or cover anyone else. What else do you have?’ ”