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Why Life Insurance is Often Used to Informally Fund a Nonqualified Deferred Compensation Arrangement

The changing demographics of the United States are having a profound effect on the labor supply in the nation. The population is aging, with the number of baby boomers reaching ages 65 and over expected to outnumber those ages 18 and under by 2034.[1] This is contributing to a tight labor market. At the onset of 2023 the labor market was historically tight with two job openings for every unemployed person. As a result, business clients are increasingly asking their financial advisors about how they can establish a nonqualified deferred compensation plan to retain their most valuable key employees.

What is a Nonqualified Deferred Compensation/SERP?

A nonqualified deferred compensation/SERP plan is a contractual agreement between the business and an executive where the employer promises to provide the executive supplemental income at some date in the future. At that future date, the earnings become taxable to the employee and deductible to the employer. Prior to that time, the employee has only an unsecured promise and stands in the same position as all other general creditors in the event the employer becomes insolvent. The plans must limit who can participate to the top 10% of an employer's workforce.

What are the Informal Funding Options?

Although employers are not required to fund nonqualified deferred compensation/SERP plans, many choose to establish an informal sinking fund to minimize the negative impact the liability (caused by the promise to pay) can have on the value of the company. Also, having a sinking fund eases the future cash flow strain that will occur when executives retire.

A business that has implemented a nonqualified deferred compensation plan has several funding options including mutual funds, stocks, bonds, and money market accounts. Gains on these alternatives are taxed to the business entity that owns the funds when realized. Annuities, which may look attractive, are generally quickly dismissed when it is recognized that tax deferred growth is not available for businesses under IRC § 72(u). Finally, there is the life insurance alternative.

Why Life Insurance?

Employer owned life insurance is frequently used to help fund the future obligation of the deferred compensation/SERP promised benefits. The reason is that life insurance is tax-efficient. In general, the tax-deferred accumulation and tax-favored withdrawals, on a non-MEC policy, combined with the opportunity to earn investment returns in a variable life insurance policy make it an attractive product to informally fund nonqualified compensation arrangements. Cash withdrawals are untaxed up to the total of premiums paid (non-MEC policies); loans are untaxed even in excess of basis as long as the policy remains in force.

Of course, the primary benefit of using life insurance to informally fund a nonqualified plan is that the policy proceeds can be designed to help provide cost recovery to the employer and/or pre-retirement death benefit to a key executive's family. By keeping the policy in force until death, the business will receive income tax-free death benefit proceeds under IRC § 101(a).

[1] *America Counts Staff. (2019, 10 December). 2020 Census Will Help Policymakers Prepare for the Incoming Wave of Aging Boomers. U.S. Census Bureau. https://www.census.gov/library/stories/2019/12/by-2030-all-baby-boomers-will-be-age-65-or-older.html*

What factors should be considered when using life insurance?

While life insurance can be an attractive vehicle to informally fund a deferred compensation arrangement, it's not for everyone. Following are the primary factors that the business owner should consider:

- **Time Horizon:** A longer time horizon enhances the benefit of tax deferral. Given a period of 10 years or longer, life insurance can work well.
- **Tax Brackets:** A high business tax rate favors the use of life insurance funding.
- **Policy Performance:** Purchasing the minimum death benefit and the use of shorter premium payment schedules typically maximizes policy cash value performance.
- **Policy Loads:** Mortality charges, policy issue and administration fees, sales loads, policy surrender charges, etc., must all be factored into the cost of using life insurance as a funding vehicle.
- **Crediting Rates:** Where a variable product is chosen, the impact of fund yields and asset management fees related to the choice of the separate accounts must be considered.

How Can DBS Help?

Life insurance can be an attractive product to informally fund nonqualified compensation/SERP arrangements. However, the arrangements must be structured carefully to achieve the desired results and comply with the IRC Section 409A requirements. Fortunately, DBS has access to products and plan support specifically designed to help serve this market. For more in-depth information on how DBS might help your business clients retain the talents of their key executives by establishing a supplemental retirement plan, contact your DBS advanced case design resource, Terri Getman, JD*, CLU, ChFC, RICP, AEP (Distinguished).

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