Executive Bonus
(Sec. 162 Plan)

Executive bonus is the simplest of the executive benefit plans. In an effort to recruit, reward and/or retain top talent, the employer agrees to pay the premiums on a life insurance policy owned by the executive. This amount is includible in the executive's compensation and is generally deductible to the employer (it would not be deductible to the extent that his or her compensation is not "reasonable" per Internal Revenue Code §162, or owners of an S Corporation).

Do you have clients who want:

- to reward key employees?
- to be able to select whom they reward with no discrimination rules?
- a plan where all contributions are tax deductible?
- a plan that is simple to administer and requires no IRS approval to implement or terminate?

If so, an Executive Bonus Plan might be the solution. An Executive Bonus Plan is a method of rewarding selected key employees by paying the premiums on an employee owned life insurance contract.

Benefits to Key Employee

- The key employee owns the life insurance contract, which can be used for survivorship benefits in case of premature death.
- The cash values can be accessed for emergencies or to help supplement retirement.
- If the key employee should leave, the policy is portable and can be funded with personal dollars.

How the Executive Bonus Plan Works

The Employer:

1. Pays the desired amount of life insurance premium
2. Has no ownership rights in the policy on the key person
3. Includes the premium on the employee's W-2
4. Deducts the premium as compensation and an ordinary business expense

The Employee:

1. Purchases a life insurance policy as applicant, owner and insured
2. Pays the income tax on the life insurance premium
3. Takes advantage of the cash value accumulation and death benefit for personal needs

Plan Design:

Typically there are three types of executive bonus plans: single bonus, double bonus and restricted bonus.

- Single Bonus - The employer pays a bonus equal to the policy premium. The employee is responsible for the income tax on the bonus. This causes the plan to become contributory, due to the employee paying the required income taxes out of pocket.
- Double Bonus - The employer pays a bonus equal to the premium and the required income tax. For example if the premium is $10,000, the total bonus would be $10,000 divided by (1 - the employee's tax bracket). If the employee was assumed to be in the 30 percent bracket, the total bonus would be $10,000 divided by 0.70, or $14,286. There is no out-of-pocket expense to the employee.
- Restricted Bonus - Many times employers are concerned with the employee's complete access to the policy's cash values. If this is the case, a restricted executive bonus plan can be designed to limit the employee's access to policy cash values. This is accomplished by adding an endorsement to the policy that requires the employer's consent before the employee can:
    1. Borrow from the cash value
    2. Surrender the policy
    3. Assign the policy as collateral
    4. Change ownership

These restrictions can be designed to expire at retirement, at a certain age, or a number of years. The employer must never have any ownership rights in the policy. The restriction must be carefully designed not to give the employer any beneficial interest, or the deduction for the premium as a business expense could be denied. The restricted plan can be either a single or double bonus.

Policy Design:

Life insurance policies are extremely flexible in their design. Two primary objectives desired from a life insurance policy are cash accumulation and guaranteed death benefit.

It is possible to maximum fund a contract, within the Internal Revenue Code guidelines for Modified Endowment Contracts, to accumulate significant amounts of cash that may be accessed in a tax favorable manner. This is done with tax-free withdrawals and loans. The cash flow can be used for a number of reasons, such as supplemental retirement income, college funding, or for emergency situations.

If death benefit is the primary objective, it is possible in today's marketplace to design a plan that can guarantee the death benefit for life. You can use a no-lapse guarantee product that would guarantee the death benefit for life, when certain conditions are met, and have the premium stop at retirement or sooner if needed.

Executive Bonus for the Business Owner(s):

In some situations, depending on the business structure, it would be cheaper for income to be taxed to the shareholder rather than the corporation. If this is true, an Executive Bonus Plan can be an excellent planning tool. However if the entity is a "flow through," such as an S Corp., an LLC taxed as a partnership or S Corp., or an LLP, the Executive Bonus Plan would increase the shareholder/ employee's W-2 income. This may not be desirable in many situations.