Blueprints for Business

Executive Bonus Arrangements Using Life Insurance

Producer Guide

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Executive Bonus Arrangements Using Life Insurance

To remain competitive and profitable, companies must constantly increase productivity through the efforts of their executives. Unfortunately, finding and retaining top executives is becoming increasingly difficult. Quality executives are in demand and salary alone may not be enough for employers to recruit and keep the talent needed to excel in the marketplace. Code Section 409A has made nonqualified benefits less attractive. Employers are looking for simple ways to attract and keep top performers.

Executive Bonus Arrangements

Executive bonus arrangements (also known as Section 162 bonus plans) can be used by an employer for the executive's purchase of life insurance. Generally, the employer pays the premium but charges the executive with a bonus in the amount equal to that payment. Alternatively, the employer could bonus cash to the executive; the executive may then use the cash to pay the insurance premium. (Please note: If the employer pays the premium directly to the insurance company or if the bonus is paid to the executive with the expectation that it will be used to purchase life insurance, then the employer may need to comply with ERISA requirements discussed later in this guide.)

The executive—or third party such as an irrevocable life insurance trust established by the executive—purchases, owns and names the beneficiary of the life insurance policy. The owner of the policy has all rights in the policy. The employer never has any right to any part of the cash value or death benefit, and at no time does the employer have any incident of ownership in the policy.

This arrangement allows an employer to determine who will receive the bonus and how large the bonus will be. The bonus, whether used to pay the policy premiums or not, is deductible by the employer if the executive's total compensation is "reasonable" for the services he/she actually renders. The bonus is taxable to the executive.

Unfortunately, the implementation of an executive bonus arrangement doesn't ensure the employer will reap the intended benefits. Any number of events could prevent the employer from realizing the results the arrangement was designed to achieve. For example the executive may:

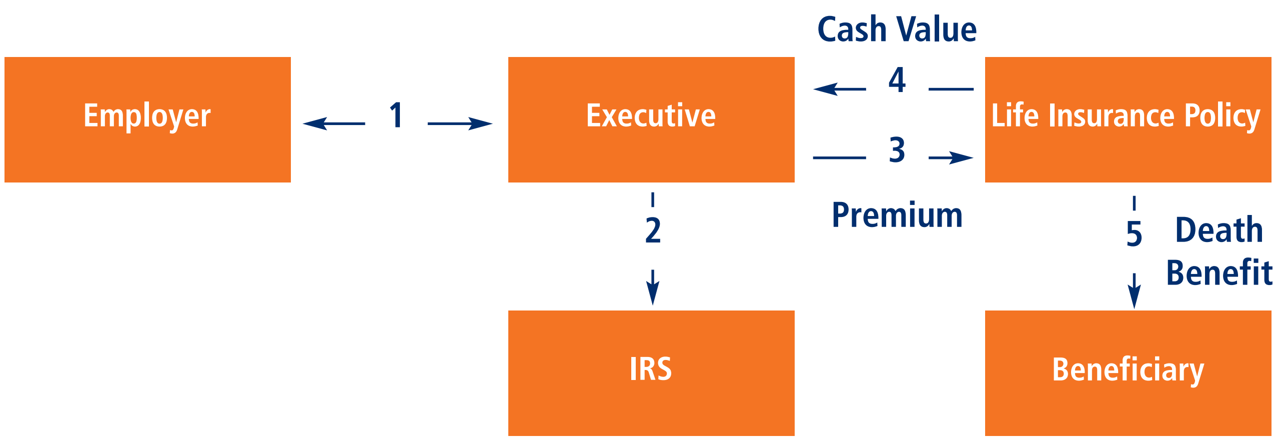
- decide to retire early,
- leave to take a job with another company,
- resign to start up a competing company, or
- engage in activities detrimental to the employer (e.g. fraud, embezzlement).

How an Executive Bonus Arrangement Works

An Executive Bonus Arrangement is a simple and straightforward method of rewarding an executive over and above the traditional salary and other benefits. Under this type of arrangement, the executive applies for, owns and names the beneficiaries of a life insurance policy. Through an executive bonus, the employer pays the insurance premium directly to the insurance company or pays the bonus to the executive who then pays the policy premium. This payment is considered ordinary income for the executive and is taxable at his or her normal income tax rate. [I.R.C. § 61(a)] The bonuses, if reasonable compensation, are tax deductible to the employer when paid. Also, employer bonuses are treated as wages to the executive and therefore subject to FICA and FUTA withholding. [I.R.C. § 162(a)(1)]

A simple corporate resolution (signed by both the executive and the employer's authorized representative) is usually all that is required to document the arrangement; the restrictions can be included in the resolution, a separate restricted endorsement agreement or in a comprehensive employment agreement. The executive's basis in the policy is equal to the sum of the premiums paid. Any policy withdrawals, surrenders or loans made by the executive are taxed as they would be if the executive had purchased the policy without the benefit of the bonus arrangement.

To be deductible by the employer, a bonus must be related to the services rendered and it must represent reasonable compensation for those services. Past services may be taken into account in establishing the amount of the bonus. If the executive's total compensation, including the bonus, is excessive and unreasonable, then the bonus may be treated as a dividend and is not deductible by the employer.



1. The employer and the executive enter into an agreement in which the employer agrees to pay the executive an annual bonus which will be used to pay the premiums on a life insurance policy. The executive's ability to exercise ownership rights will be subject to restrictions specified in the agreement or in a separate employment agreement. Bonus payments are tax deductible by the employer (assuming total compensation is reasonable).
2. Executive pays tax on bonus as ordinary income.
3. Executive applies for, purchases and owns life insurance policy.
4. Executive may receive income through withdrawals and loans from the policy's cash value, subject to any restrictions included in the agreement.[1]
5. At the executive's death, income tax-free death benefit proceeds are paid to the executive's named beneficiary.

[1] If the policy lapses or is surrendered, the IRS will tax distributions received over the life of the policy and at termination that are in excess of total premiums paid.

Advantages of Executive Bonus Arrangements

The benefits to an employer offering executives an executive bonus arrangement include:

1. A reward to the selected key executives.
2. Amounts of insurance coverage on various executives and the amounts of their bonuses can be different for each executive.
3. The size of the bonus from year to year can vary to reflect the value of each executive's work and the current profitability of the company.
4. Arrangement can be terminated without IRS notification, approval or restrictions.
5. Contributions are fully deductible if the executive's total compensation is reasonable.
6. Arrangement is relatively simple to implement and administer.
7. The executive can agree (through a policy endorsement) not to change ownership or borrow against the policy for a period of time without the employer's consent.
8. An executive bonus arrangement may not be required to comply with Section 409A and its regulations. However, the employer and executive should consult with counsel regarding the executive bonus arrangement design and the possible consequences under 409A.

The executive also enjoys a number of distinct advantages through a bonus arrangement including:

1. Arrangement can be customized to meet the executive's individual needs.
2. Beneficiaries will generally receive the insurance death benefit Income tax free at the executive's death [I.R.C. § 101(a)(1)].
3. Policy cash values potentially grow Income tax deferred and can be available to the executive for emergencies, retirement or other needs with the employer's consent.[1]
4. The executive may voluntarily contribute personal funds to arrangement to potentially increase cash value growth and supplemental retirement income.[1]
5. Retirement benefits can be accessed Income tax free through proper structuring and use of withdrawals to basis and policy loans as long as the policy remains in force.[1, 2]
6. Executive owns the policy (and cash value) and is fully vested from the start of the arrangement.[1]

[1] Restrictions may apply to the extent that IRC §409A applies to the arrangement.

[2] Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Policy loans and withdrawals may reduce the policy's cash value and death benefit. This assumes the policy qualifies as life insurance and does not lapse.

Executive Bonus Arrangement Design Options

Using an executive bonus arrangement, an employer can reposition dollars that might otherwise be spent on executive group term coverage. An executive bonus arrangement can be used to "carve out" selected executives from an employer's group term life insurance plan and instead create post-retirement or permanent benefits for them. Viewed as a whole, there is a great deal of flexibility in designing both premium payment schedules and benefits under an executive bonus arrangement.

Pre- and post-retirement death benefit

An executive bonus arrangement can be designed to simply provide life insurance protection both before and after retirement. Premium payments may be made until the executive retires, or premiums may be paid over a shorter period of time through the use of the various types of cash value contracts available. Funding a policy sufficiently to potentially allow the life insurance to continue beyond the premium paying period may benefit the employer by shortening the premium paying period as well as benefit the executive with the advantage of owning a portable policy.

Supplemental retirement income

An executive bonus arrangement can be designed to provide a potential source of supplemental income for an executive during retirement while continuing to provide post-retirement life insurance protection. During the executive's life, the policy's cash value may accumulate on a tax-deferred basis. As long as the policy is not classified as a "modified endowment contract," the executive can make withdrawals to basis and loans that will not be subject to income tax.[1] As long as the policy remains in force until the executive's death, the income tax on policy distributions over the executive's basis can be permanently deferred, although the policy's death benefit will be reduced. (The policy's basis is equal to that portion of the bonus actually paid as premiums.) But gain over basis will be taxable if the policy lapses or is surrendered before the executive's death.

Estate liquidity

For estate tax purposes, inclusion of the policy proceeds in the gross estate of the executive/insured can be avoided if the insured has no incidents of ownership in the policy at the time of his or her death or within three years prior to death. In situations where a decision is made to establish an irrevocable life insurance trust (ILIT) to own a newly issued policy, the estate inclusion three-year rule [I.R.C. § 2035(d)] can usually be avoided by simply having the policy applied for by the ILIT trustee and issued to the trust as owner. In circumstances where the ILIT is established to own an existing policy, the risk of an early death causing the policy proceeds to be included in the insured's gross estate will remain for the three-year period following the transfer. When designing an executive bonus arrangement for estate tax purposes, normal gift-tax consequences would apply to any gifts made to the trust to pay the insurance premiums or any transfers of an existing cash value policy to a trust.

Paying the executive's additional income taxes

The employer's payment of the bonus to the executive (or to the insurance company for the executive's benefit) results in taxable income to the executive; he/she is responsible for paying the income taxes that are due as a result. This increase in income taxes can be a problem for the executive. Several executive bonus arrangement design alternatives are available to deal with this income tax problem. Planning for paying the income taxes is essential, particularly when the employer pays the policy premium directly to the insurance company. The executive may find him/herself in the position of having a large additional income tax liability without the cash to pay it. This could be especially disconcerting to the executive because the asset creating the tax liability may not be accessible for many years. If an executive receiving an executive bonus arrangement benefit is to see it as a reward for good work and an attractive incentive, it must include an acceptable strategy for paying taxes.

[1] If the policy is a modified endowment contract (IRC Section 7702A) distribution from the policy (by loan or withdrawal) will be taxable as ordinary income to the extent of the gain in the policy and may be subject to a 10% income tax penalty prior to age 59 ½.

Zero Net Outlay or 'Double' Bonus Arrangements

In addition to a bonus in the amount sufficient to pay the annual premium, the employer may also bonus an additional amount to cover the executive's income tax on the bonus itself. In fact, an additional bonus to pay the executive's increased income taxes may be advisable since the restrictions may not permit the executive to access policy cash values to pay the income taxes due on the bonus. Thus, it often makes sense to increase the bonus so that after the executive pays the income tax on the bonus to pay the insurance premium, his or her net out-of-pocket outlay is zero.

Example: Suppose that the annual premium is $10,000, and the executive is in a 31% tax bracket.
To pay the premium and the tax on the bonus itself, the employer could bonus the executive $14,493 [$10,000 ÷ (1 - 0.31)]. The tax on $14,493 at 31% is $4,493, leaving $10,000 to pay the insurance premium.

Executive Borrows Funds to Pay the Income Taxes

It may be possible for the executive to borrow the money needed to pay the taxes. There are two potential sources of loan dollars:

Bank Loan If the executive has reasonable credit and collateral sources beyond the policy, he/she may go to a bank or commercial lender each year and take out a loan. The loan proceeds could be used to pay the taxes. At the executive's death, part of the policy death benefit could be used to pay back the loan. This approach can be attractive if paying the interest on the loan balance is less expensive than the amount of the income taxes.

Loan from Employer Instead of borrowing from a bank, the executive may be able to borrow the amount needed to pay income taxes from the employer. Such a loan could be at a fair market interest rate or the rate could be below market. In fact, the loan could even be interest free. A below market or interest free loan creates imputed income for the executive which would also be taxable. Despite this additional income tax cost, it may still make economic sense for the executive to borrow from the employer instead of a bank/commercial lender. The executive's tax and legal advisors should be consulted for a full analysis of this option.

Combination It is possible to use a combination of these strategies. For example, the employer could give the executive an additional bonus to pay part of the income tax costs and could lend him/her the remaining funds needed. Or the employer could lend the executive part of the funds and the executive could borrow the balance from a bank or other commercial lender.

Employer May Consent to Executive Use of Policy Cash Values

Depending on the type of policy and its current level of cash value, it may make sense for the executive to withdraw or borrow enough of the policy's cash value to pay the income taxes. If the employer is not going to supply the funds the executive needs to pay the taxes, the employer can consent in writing to the executive's use of policy cash values for this purpose.

ERISA Issues

An **unrestricted bonus** which the executive voluntarily uses to purchase a life insurance policy would most likely not be considered an ERISA plan. However, if an employer pays the premium directly to the insurance company or provides a bonus to the executive with the expectation that it will be used to pay for a life insurance premium, then the bonus arrangement may be considered an employee benefit plan under ERISA even if only one executive participates in the arrangement. The odds of the plan being considered an ERISA plan may increase when the executive and the employer agree that the employer may prevent the executive from exercising certain policy rights for a period of time as is the case in an executive bonus arrangement.

ERISA may define a bonus life insurance arrangement as an executive welfare benefit plan or an executive pension plan or both:

- A welfare benefit plan is a plan established or maintained for the purpose of providing to participants, or their beneficiaries, through the purchase of insurance or otherwise, benefits including medical, surgical, or hospital benefits; benefits for sickness, accident, disability, death, unemployment or vacation; or benefits under Section 302(c) of the Labor Management Relations Act of 1947.
- A pension plan is a plan established or maintained by an employer to provide retirement income to executives, or which results in deferral of income by executives for periods terminating at or after retirement.

There are some employers that take the position that a bonus plan is not an ERISA benefit plan, but merely an increase in taxable compensation to the executive, or an employment contract. Other employers take the position that a bonus life insurance arrangement is an ERISA plan. The employer's tax and legal counsel should be aware of this issue and should advise the employer as they see fit.

Welfare Benefit Plans

For those employers that assume the bonus arrangement is an ERISA plan, many take the position that the bonus arrangement is a welfare benefit plan under ERISA because they argue that it simply provides a benefit in the event of death. Most unrestricted bonus arrangements would probably be considered welfare benefit plans. Restricted bonus plans where the restrictions are removed well before normal retirement age or before the executive is eligible to retire, may also be seen as welfare benefit plans for ERISA purposes.

As a welfare benefit plan, a bonus arrangement would require limited reporting for ERISA compliance. However, a plan that is properly structured to meet top-hat requirements may be exempt from Title I of ERISA except for providing plan documents to the Secretary of Labor upon request and having a claims procedure in place. It would still be subject to ERISA fiduciary requirements.

Pension Plans

A bonus life insurance arrangement may also be considered a pension plan under ERISA if the result is to provide retirement income to the executive. Certain types of bonus plans are more likely to be determined to be pension plans under ERISA. For example, a plan that is designed to produce large cash values relative to the death benefits might be a pension plan. Also, if a bonus plan includes vesting provisions or requires a restrictive endorsement that is released at or near retirement, it might be considered a pension plan under ERISA. This determination is entirely a factual one that must be made by qualified legal and tax advisors. For example, a 10-year restriction for a 55-year-old executive may create a pension plan whereas a 10-year restriction for a 35-year-old may not.

There is a top-hat exemption from most Title I requirements for pension plans if the plan is unfunded and established primarily for the purpose of providing retirement income for a select management group or highly compensated executives. However, it is doubtful that a bonus arrangement using life insurance would be classified as "unfunded." Therefore, to avoid being characterized as a pension plan under ERISA, a bonus plan should be designed and intended to primarily provide death benefits. The cash values in the policy should be incidental to the death benefit, and the plan language and other executive communications should reflect this fact. If an executive bonus arrangement has a restrictive endorsement, it should be removed well before retirement. Finally, a vesting schedule might be viewed as a factor supporting pension plan status. When considering implementing an executive bonus arrangement, careful planning must occur with the assistance of qualified legal and tax advisors.

Marketing Opportunities

An executive bonus arrangement can be an attractive option for employers looking to provide selected key employees with an incentive that is easy and inexpensive to administer. Typically, all that is needed is a simple corporate resolution establishing the arrangement. Some of the prospects for an executive bonus arrangement include (but are not limited to):

1. Any closely held business with non-owner key executives;
2. Small businesses where qualified plans are too expensive;
3. Group term carve-out opportunities where additional insurance benefits are provided to a select group of executives "carved out" of a group term plan;
4. Companies in a higher tax bracket than the executive where the combined tax paid can be reduced;

Example: Employer is in a 34% tax bracket and the executive is in a 28% tax bracket. When the employer bonuses $10,000 to the executive, the employer's cost after the $10,000 tax deduction is only $6,600. The executive pays $2,800 in taxes on the bonus leaving $7,200 that can be used to help pay the insurance premiums. The net tax savings using an executive bonus arrangement is $600 [(34% - 28%) x $10,000].

5. Companies wishing to find a replacement for qualified plan benefits;
6. Providing a premium source to fund a cross-purchase buy-sell between shareholders.

Almost any type of insurance can be purchased as part of a Section 162 bonus arrangement including disability policies, long-term care policies, term or cash value life insurance. By using traditional life insurance, employers can offer a meaningful and portable benefit that may be structured to provide key executives with family death benefit protection, supplemental retirement income and/or estate liquidity.

Conclusion

Employers need techniques to reward and retain key executives. In the current tax environment, executive bonus arrangements often make sense. They provide significant death and retirement benefits to executives, while allowing the employer to retain a degree of control over those benefits. They offer tax-efficient vehicles for employers and executives to accumulate retirement funds, and they can be structured to provide post-retirement life insurance coverage. They can be a simple and effective alternative for employers who don't want to deal with the restrictions required for nonqualified deferred compensation plans under Code section 409A. Like NQDC arrangements, executive bonus arrangements can "tie" key executives to the company. The longer the executive stays with the company, the larger the potential benefit.

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