Section 162 Bonus Arrangements as Value-Added Retention Devices: Variations on a Theme

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Abstract

This paper describes, using relevant examples and references to the Internal Revenue Code, Section 162 executive bonus plan arrangements. The advantages and disadvantages of Bonus Arrangements are presented. A significant employer advantage associated with this type of plan is that contributions to the plan are tax deductible, even though the plan is considered to be discriminatory. The paper concludes by suggesting that executive bonus plans can be a win-win benefit for the employer and employee, and that often these plans can be used as a valuable tool in employment contract negotiations.

Introduction

An executive bonus plan involves the purchase of a life insurance contract on the life of an employer-selected key executive and the payment of premiums on that policy by the employer in the form of a bonus. The contract of insurance is owned from the outset by the executive or by a third-party. The executive names the beneficiary of the contract and has all the rights of ownership in the contract. There is no sharing of any incident of ownership with the employer.

The executive bonus plan is so named because the employer can deduct the amount of the bonus to the covered executive under Sec. 162(a)(1) of the Internal Revenue Code of 1986, as amended, which relates to ordinary and necessary business expenses. Mechanically, the employer pays the bonus in the form of premiums sent directly to the insurer. The entire premium paid by the employer under an executive bonus arrangement is charged to the insured as ordinary compensation income and reported on the executive's IRS Form W-2. Each bonus is subject to FICA and FUTA tax. The bonused premiums are considered a non-cash fringe benefit for withholding purposes, so that the premiums will be added to regular cash wages paid during the year and the appropriate withholding adjustment will be made.

Example One

Doug, an executive of WidgetWorld, enters into an executive bonus life insurance plan as described above. WidgetWorld pays a premium on Doug directly to the insurer each year in the amount of $10,000. Doug was earning a salary of $100,000. Doug's W-2 for this first year of the executive bonus arrangement will reflect compensation of $110,000.

In some cases the executive may choose to enhance the retirement and death benefits under the plan by making voluntary additional (after-tax) contributions to the premium.

Example Two

Hanna is forty-five years old. Her employer increases her salary by $10,000 per year in an executive bonus. She is in a combined income tax bracket(s) of 40%. She adds $4,000 of her own after-tax dollars and pays it into the contract as well so that the life insurance company receives $14,000 yearly on the contract. The contract requires a premium of $10,000 and has a death benefit of $250,000. After 20 years, when Hanna has reached age 65, the death benefit on the insurance contract will have grown to a range of $700,000 to $800,000+ (depending on the type of contract – whole life, variable, universal) and the cash value will be in the neighborhood of $400,000 to $500,000+. The employer will have laid out somewhere around $132,000 ($6,600 per year after its tax deduction) in the twenty years, and Hanna will have paid out of pocket approximately $80,000.

In many cases, the employer will assist the employee even further by paying an amount sufficient to pay both the premiums and the tax on the bonus. This is often called a "double bonus" or "grossing up." The formula for giving the executive enough so that after paying taxes he can pay the premium is:

Policy Premium / (1 – Tax Bracket of the Executive)

Example Three

Donald is a highly prized financial executive. Donald is in the 40% combined marginal tax bracket. Donald's employer wants to create an executive bonus plan for Donald. The premium will be $100,000 and it will contain a gross-up. The employer will have to bonus out $166,667 to Donald so that both the premium and the taxes on the bonused premium can be paid. The bonus out figure was calculated as follows: $100,000 / (1 - .40 = .60) = $166,666.67.

Planning and Analysis

The ideal employer candidate for an executive bonus arrangement is a business in a relatively high combined income tax bracket that wants to provide fringe benefits to favored executives in a lower income tax bracket. Section 162 executive bonus arrangements are often chosen as part of a group carve-out to replace excess pre- and post-employment group-term life insurance.

In many instances, an employer's savings from a reduction in group-term life insurance premiums will provide a substantial portion of the premiums for the Section 162 executive bonus arrangement. The employer's after-tax additional cost is merely the difference between the amount of premiums that would have been paid for the excess group-term life insurance and for the bonus arrangement, since both outlays are fully deductible. Many executive bonus arrangements are used to supplement pension or profit sharing programs.

In general, the insurance proceeds will be received income tax-free by the executive's estate or named beneficiary under the policy pursuant to Internal Revenue Code (IRC) section 101(a). However, where the beneficiary elects a settlement option rather than a lump sum, the installment payments are partially taxable. The portion of each payment attributable to interest is includible in income. Where the insurance company pays life insurance proceeds after the executive's death, the amounts held by the insurer are prorated over the period for which payments are to be made, and a portion of each payment made to a beneficiary is excluded from the beneficiary's income under section 101(d). If the interest only settlement option is chosen, the interest income is taxable to the beneficiary under section 101(c).

Under traditional executive bonus life insurance, the executive owns the policy and therefore, the entire amount of the policy proceeds will be included in the executive's gross estate regardless of who is the named beneficiary under section 2041(1) of the IRC. Of course, if the executive's spouse is the beneficiary, the estate tax marital deduction will protect the estate from any increased estate tax liability caused by the inclusion. However, if the spouse predeceases the executive the marital deduction is not available.

Reasonable Compensation

Under Section 264(a) of the Code, premiums paid by an employer for life insurance are not deductible. However, an executive bonus

arrangement requires an employer payout in the form of a bonus, the premiums are therefore deductible as compensation subject only to the limitation that the entire or total package of compensation is reasonable.

The general nondeductibility rule of Sec. 264 does not apply to executive bonus plans. Legally, the contract for insurance is owned personally by the executive or by his or her assignee and although the employer may actually pay the premiums, it has no interest in the policy or proceeds.

Employer deductibility assumes that the amount of the premiums paid on behalf of the executive will be classified as reasonable, an issue which generally only arises where the executive in question is also a shareholder. If the total amount is more than what is considered reasonable, the excess may be taxed as a dividend rather than as compensation. The corporate tax deduction would then be disallowed.

Ordinary Expenses Defined

There are three requirements to be met for an expense to be deductible. First, it must be "ordinary" and "necessary." For an expense to be ordinary, it must be one that could normally occur in the course of the plan sponsor's business. To be considered necessary, it must be helpful (not essential) in maintaining a trade or business. Both of these conditions must be present for the expense to be deductible. In addition the expenditure must be reasonable as to the degree of compensation awarded to the executive.

Second, the expense must be "paid or incurred" in the year that it is deducted. This depends primarily upon whether the employer is a cash basis or accrual basis taxpayer. The final requirement is that the expense be incurred in the conduct of a trade or business. To this end, executive bonus life insurance is considered an executive benefit.

For executive bonus life insurance plans to be deductible to the plan sponsor, the expense must be made for personal services actually rendered. This is the case whether the employer pays the premium directly or makes a bonus of this amount to the executive who then pays the premium. Rev. Rul. 58-90 states that for the company to be allowed a deduction for premiums paid for a policy owned by an executive, the following conditions must be present: (a) the premium must constitute compensation to the executive, (b) the total amount of the compensation paid to the executive *must not be unreasonable*; and (c) the employer must not be a beneficiary of the policy, either directly or indirectly.

For compensation that is otherwise deductible in a taxable year beginning after 1993, the Revenue Reconciliation Act of 1993 added a new IRC section 162(m) limiting publicly held corporation's deduction for compensation paid or accrued with respect to a "covered employee" to $1

million per year. The statute does not modify or change the reasonableness requirement of section 162(a)(1), which continues to apply to the $1 million limit.

The following types of compensation are not subject to the limitation and therefore are not counted in determining whether a covered employee's other compensation exceeds the $1 million threshold:

- commissions;
- remuneration payable solely because the executive attains performance goals if certain outside director and shareholder approval requirements are met;
- contributions to a qualified retirement plan (including salary deferrals);
- amounts that are excludable from the executive's gross income (including tax favored welfare benefits such as group term life insurance coverage up to $50,000)

Under IRC section 61, gross income includes "compensation for services." Therefore, the amount paid as a bonus to the executive is considered income. This is the case whether the employer pays a bonus to the executive so that the executive can pay the premium or the employer pays the premium directly to the insurance company. Also, since the bonused amount is considered "remuneration for employment" and taxable to the executive as income, such bonus amount becomes subject to both FICA (social security) and FUTA (unemployment) taxes.

Group Term Carve-Out Described

For businesses trying to retain key executives, offering life insurance as an employee benefit can be beneficial for both employer and employee. As an executive benefit, however, group term life insurance does not provide 'much bang for the buck.' Under Section 79(c) of the Internal Revenue Code, executives pay income taxes on company paid premiums that buy more than $50,000 worth of insurance. The rates on this tax rise with age, accelerating quickly for executives over age 55. Group life benefits exceeding $50,000 are also subject to Social Security tax. In many cases, an executive can buy individual term coverage for less than the taxes paid on comparable coverage from a group life plan.

In addition, group term life usually isn't portable. Executives can't take it with them when they change jobs or retire unless they convert to individual policies - an expensive proposition and undertaking. It isn't a stretch to imagine an executive facing retirement, contemplating conversion of his or her group term life, only to find the insurance company will be reducing benefits as part of the underwriting requirements of the insurance company.

In fact, group life is not even a good deal for employers. Group life premiums often rise substantially when companies buy additional insurance for their executives. That's because the premiums are based on mortality rates that assume a certain demographic makeup. Since executives are frequently older and have a poorer mortality experience, the extra coverage can prove very expensive. Group life premiums rise dramatically for executives over age 40.

By carving out part of a group life plan and replacing it with individual permanent life policies a plan sponsor can reduce or even eliminate its costs for executive life insurance while providing key executives an enduring asset. Because executives covered under individual permanent life policies usually must show proof of insurability, the mortality charges, and thus the premiums, for these policies are less.

Applying the Strategy

Companies generally retain $50,000 of group life for their executive to take full advantage of group life tax benefits. In doing so, the plan sponsor also provides valuable coverage for executives who may be uninsurable under individual policies.

The *executive bonus plan* is of greatest advantage to the executive as a carve-out technique. The company pays policy premiums (usually through a bonus to the executive) and the executive enjoys full policy ownership. Company paid premiums are deductible by the company and taxable to the executive as current income. But, unlike group life, the policy has a cash value that executives can tap for future income. Variations on the carve-out theme include providing the "cost" of group-term life as the employer contribution and the executive contributing that which is desired.

Upon leaving the company, the executive can maintain the policy or surrender the policy for the cash value and pay any income tax on the gain. An executive who maintains the policy owes no tax unless the policy's cash value exceeds its tax basis in the policy ("tax basis" generally can be defined as the amount of premiums paid).

Restrictive Endorsement or "Silk Handcuffs"

The basic executive bonus arrangement fails to address two very key employer issues, namely, reducing executive turnover and limiting executive's use of company money to compete with the employer. A viable solution to putting all parties involved at ease with respect to administration, safety, and control is the use of a Restrictive Executive Bonus Arrangement ("REBA") or an "employer bear-hug." A REBA is based upon an

employment agreement signed by the employer and the executive specifying the terms of the plan. The agreement should also clearly state that no promise of continued employment arises as a result of participation. The agreement lays out how to pay the bonuses into the life insurance contract as well as any moneys for gross-up. It is in this employment agreement that many of the unique and creative opportunities available become apparent. These include 401(k) enhancement, group carve-out, performance sharing, target purchase, and other benefits.

Administratively, the plan is as simple as any executive bonus arrangement using life insurance. The employee is granted safety from employer insolvency or takeovers by owning the life insurance contract personally. However, the employer retains an element of control through the use of a *restrictive endorsement* to restrict certain rights of the employer.

Restrictive Endorsements

The restrictive endorsement is a policy form provided by an insurance company's home office or the drafting attorney's office for the plan which is executed by the employer and the executive to restrict the executive's ownership rights. The executive retains the right to change beneficiaries, but the exercise of other policy rights requires the written consent of the employer. The endorsement's specific purpose is to prevent the employee from withdrawing money from the policy upon early termination. It is designed to expire at a specific future date, typically an attained age, retirement date or date at which the employee becomes fully vested in bonuses/stock rights/options as stated in a separate employment contract. The endorsement may also may also specify expiration upon bankruptcy or dissolution if either should happen prior to an otherwise stated expiration date. The executive should be assured that the endorsement does not give the employer any policyowner rights, including right to recover policy values. Instead, the endorsement simply states that the employer must consent to any decisions that will affect the utilization of policy values prior to expiration of the restrictive endorsement.

Issues of taxation and deductibility

The taxation and deductibility of a REBA follow that of the traditional executive bonus arrangement under section 162 of the Internal Revenue Code. In other words, premiums are paid and deductible to the employer via a bonus to the employee, who in turn pays income tax on the bonus amount. The employer may take a current deduction for amounts contributed to the REBA when the employee files (on an annual basis) a section 83(b) election. Under section 83(b) of the IRC, amounts that would

otherwise not be includable as income may be included at the taxpayer's request by filing an election to be taxed under section 83(b). *If such an election is filed, the executive will be taxed on the full amount of the bonus notwithstanding the restrictive endorsement and the employer will be permitted a deduction.*

The restriction phase is critical to the program. This restriction takes the form of a policy endorsement that forbids access to the policy values by the owner of the policy (executive) without the employer's permission.

In summary, employment agreement should address, at a minimum, the following issues: (a) vesting, (b) wait and hold restriction, (c) reversion restriction, (d) change in control, and (e) insolvency.

Executive Bonus Plans and ERISA

An executive bonus arrangement is a "welfare benefit plan" as defined by Sec. 3(4) of the Employee Retirement Income Security Act of 1974, as amended, because an executive bonus arrangement is providing (among other things) a "death benefit." A REBA will also be considered an "employee welfare benefit plan" under ERISA.

This is not as cumbersome as it seems upon first glance. An insured welfare plan maintained by an employer to provide benefits to a "select group of management or highly compensated employees is exempt from ERISA's reporting and disclosure requirements, except the requirement to provide copies of the plan documents to the Secretary of the Department of Labor upon request. Therefore, if a bonus life insurance plan provides benefits only to this select group (also known as a top-hat group) it effectively escapes the brunt of ERISA's reporting and disclosure requirements.

Under ERISA section 402, a REBA, especially where the plan sponsor pays the premiums directly to the insurance company is subject to the fiduciary requirements of Part 4 of Title I of ERISA. Part 4 requires a written plan document and appointment of a "named fiduciary." For a REBA, these requirements are easily satisfied. The plan sponsor's adopting resolution will serve as the written plan instrument while an officer of the employer is usually designated as the named fiduciary.

Finally, under ERISA section 503, a REBA as a life insurance plan must have a claims procedure that will provide written notice to employees or beneficiaries when claims are denied and details for the denial written in plain language. In addition, the claims procedure must afford the beneficiary with a reasonable opportunity to get a full and fair review of the denial b the named fiduciary.

Summary

The Bonus Arrangement is the only discriminatory executive benefit arrangement which allows for the employer to provide a valuable benefit and still deduct its cost. Executive tax cost can be eliminated where a "double-bonus" or "gross-up" plan is implemented.

The Restrictive Endorsement Bonus Arrangement has all the elements of deductibility for the employer and adds one very important feature in favor of the employer...the silken handcuffs. Those silken handcuffs require employer consent to surrender the policy, borrow from the policy, assign the policy as collateral or change ownership of the policy. Typically speaking, the restrictive endorsement will expire upon the occurrence of the earliest of any of the following: (a) bankruptcy or dissolution of the employer, (b) release by the employer, (c) employee attainment of a specified age, or (d) employee retirement

While the restrictive endorsement is a separate agreement from the policy that allows the plan to escape ERISA coverage, the more restrictions that are placed upon an arrangement other than the above will give rise to the argument that the arrangement is a deductible, funded plan for ERISA purposes. Such a conclusion will give rise to the full reporting and disclosure found under Title 1 of the Employee Retirement Income Security Act of 1974, as amended. The REBA itself is a win-win for the employer and the employee and is often an icebreaker in employment contract negotiations hinging on security of benefits.

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