Section 162 Executive Bonus Plan

Providing For Key Employees

With the onerous Deferred Compensation rules contained in Internal Revenue Code Section 409A along with the lack of tax deductions in funding, many employers are turning to Section 162 Executive Bonus Plans to provide for key employees. An Executive Bonus Plan is a way to provide additional benefits to key employees while being able to discriminate as to who receives the benefits. With a section 162 Executive Bonus Plan, the company pays either the employee or the insurance company directly a bonus amount in the form of a premium for a life insurance or annuity policy. The company determines who can be a part of the plan, how much to contribute and whether they prefer a life insurance policy or a deferred annuity.

Implementation

The employer must determine what they are trying to accomplish when creating and designing an Executive Bonus Plan.

If a life insurance policy is chosen, the employee will have a death benefit that completes the plan and a living benefit if the employee chooses to use it as such.

If an annuity is chosen, the employee obtains tax deferred growth on the money bonused into the annuity policy and will have a benefit at retirement. An annuity allows the employer to vary the annual bonus or even skip a year if business is down.

What are the responsibilities of each party?

Employer:

- Determines how much life insurance or what the size of the annuity will be based upon how much they are willing to bonus out each year.
- Either pays the employee directly or makes premium payments directly to the life insurance/annuity company.

Employee:

- Applies for and owns the life insurance policy or annuity.
- Names the beneficiary.

How can an Executive Bonus Plan be implemented to retain Key Employees?

- **Payback Agreement:** The employer may enter into a side agreement with the employee that if the employee leaves the employer's employment prior to a certain specified date, the employee will be required to pay the bonuses received back.
- **Vesting Schedule:** the employer can provide a vesting schedule whereby if the employee leaves the company prior to full vesting, the employee will be required to pay back the unvested amount.

Tax Impact

Under a section 162 Executive Bonus Plan, the employee takes each year's bonus into taxable income as received or when the premium is paid by the company. Some companies will gross up or pay an additional bonus to pay for projected income taxes and payroll taxes attributable to the bonus. Since the employee owns the life insurance policy or non qualified deferred annuity, they will have access to policy values.

In that the employee takes each bonus into income, the employer may deduct each bonus. The only exception to the bonus being deductible is if the IRS would rule that the employee's total compensation is unreasonable. If that is the case, the employer would be limited in how much they can deduct but the employee would still take all of the compensation into taxable income. See IRC Regulations.1.162-7(b) (3).

What are the **ADVANTAGES** to each party?

Employer:

- Employer selects which executives they wish to benefit
- Employer chooses benefit level and can customize for each executive
- 162 Executive Bonus Plan easy to implement and administer
- No administration other than regular payroll
- Bonuses may be fully deductible to employer under IRC 162
- Rewards and retains Key Employees
- Plan can be terminated by company at any time

Executive:

- Employee owns the policy and policy values
- Employee gets to name beneficiaries
- Accumulating values can be accessed by employee
- Tax deferred growth on accumulations
- Tax free death benefit in case of Life Insurance
- Life insurance can benefit survivors and pay estate costs
- Cash values available for emergencies
- Cash values may be used to supplement retirement income

What are the **DISADVANTAGES** to each party?

Employer:

- The company has very little control of the life insurance policy or annuity

Executive:

- The Key Executive must include the bonus paid in their taxable income
- If an annuity is used, an IRS penalty of 10% may apply on withdrawals from annuities prior to age 59½
- Withdrawals from a life insurance policy will impact cash value and death benefit