Executive bonus arrangement

Highlights & fact finder

Transamerica℠

A rewarding way to retain key executives

Executive bonus arrangements, also referred to as IRC §162 arrangements, can be an effective way to reward select employees or owners while providing tax deductions for employers. Using an executive bonus arrangement, businesses can provide their key executives or owners growing cash values in the form of company-paid, cash-value accumulation life insurance policies.

Implementing this strategy is simple, since the arrangement is easy to administer and exempt from annual reporting and ERISA requirements.

The benefits of an executive bonus arrangement

For the business:

- Distinguishes its compensation package as a way to attract and retain key employees
- Provides selected employees with attractive pre- and post-retirement benefits
- Bonuses paid are tax deductible (as long as total compensation is reasonable)
- No IRS approval to implement or terminate an arrangement
- No administration cost
- Customizable to each individual entering into the arrangement

For the executive:

- Enjoys tax-deferred growth of life insurance policy cash value
- Provides federal income tax-free death benefit protection for named beneficiaries
- Owns the policy and has access to an additional source of income to help meet financial goals*
- Can save more for retirement, since the plan is not subject to limitations set forth by statute on qualified plans

For business owners who want to take advantage of this strategy themselves, special consideration should be given to the tax benefits for the business entity as they compare to the potential tax on additional compensation received by the owner as an individual tax payer.

Executive bonus arrangements using life insurance are ideally suited for:

A.

Companies that want to recruit and retain key employees

B.

Companies that want to offer benefits in excess of those offered by their qualified retirement plan

C.

Companies that want to offer these benefits to a select group of employees

* Loans and withdrawals will lower the policy value and net cash value and will lower the death benefit or cause the policy to lapse. Withdrawals or distributions may have adverse tax consequences, so please consult your tax professional. If the policy is considered a Modified Endowment Contract (MEC), distributions are treated first as taxable distributions of earnings in the policy. Withdrawals, loans, and assignments are considered distributions. Taxable distributions from a MEC prior to age 59½ may also be subject to a 10% federal income tax penalty.

How it works

1. Purchasing the life insurance policy
Executive purchases life insurance policy in which he/she owns the policy and can name their own beneficiaries.

2. Bonus incentive income
Company pays the life insurance premiums as an executive bonus.

3. Accessing the policy cash value
Executive can use the policy's accumulated net cash values to help meet other financial goals.

4. Beneficiaries
As long as the policy remains in force, designated beneficiaries will receive a life insurance death benefit free of federal income taxes at the time of the executive's death.

An executive bonus arrangement can be an essential part of a comprehensive executive compensation package.

Employers can recruit and retain key associates by offering a valuable financial perk – death benefit protection and the tax-advantaged cash value of life insurance.

Step 1. Purchasing life insurance

- After considering risk tolerance, time horizon, and financial goals, the executive purchases an appropriate life insurance policy.
- The executive is the policy owner and can name his or her own as beneficiary.

Step 2. Bonus incentive income

- The life insurance policy premiums are paid by the employer as a taxable bonus to the executive.
- For the company, the bonus paid under the executive bonus arrangement is generally treated as tax-deductible employee compensation pursuant to Internal Revenue Code section 162.

Step 3. Accessing the policy cash value

- The executive can use the policy's accumulated net cash values to help meet other financial goals.

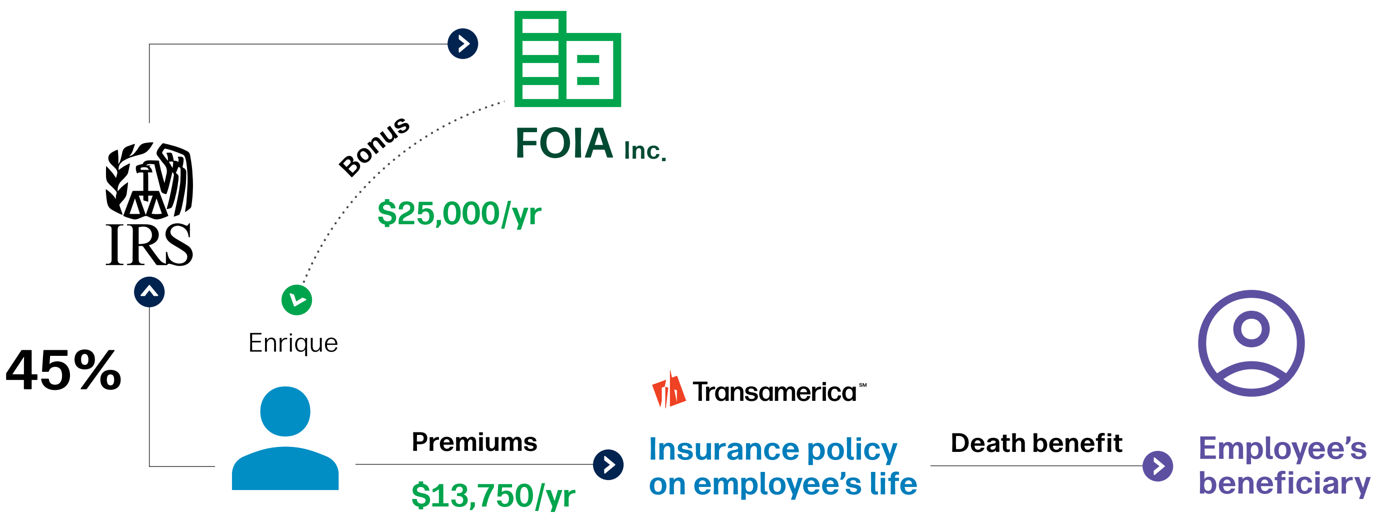
Step 4. Beneficiaries

- In the event of the executive's death, named beneficiaries will receive a life insurance death benefit free of federal income taxes.

Double bonus

A double bonus occurs when the employer pays the premiums on the executive's insurance policy via a bonus, and then increases the bonus to include the estimated income tax impact that will be owed on the entire bonus. The double bonus essentially covers both the cost of the permanent life insurance policy and the income taxes due on the bonus. A double bonus is a widely used and accepted practice for lessening the tax impact to executives who are chosen to participate in an executive bonus arrangement.

To determine the amount that needs to be paid as a double bonus, divide the amount of the premium by 1 minus the executive's total tax rate. The total tax rate should include the federal income tax as well as any applicable FICA, state, and local taxes. For example, if the premium is **$13,750** per year and the tax rate is **45%**, the calculation would be **$13,750** per year divided by **0.55 (1 - 0.45)**. This produces a double bonus amount of **$25,000**.

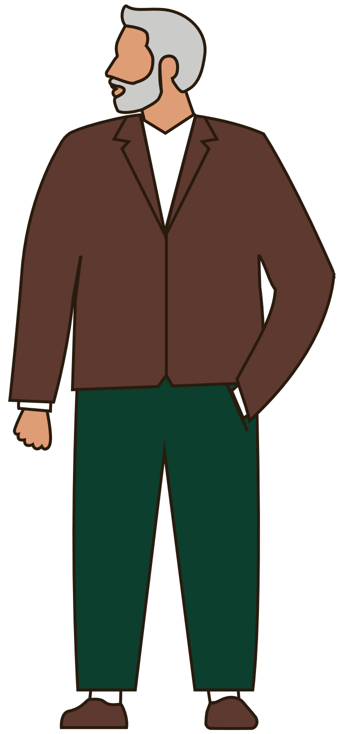


Implementation of the arrangement

Implementing an executive bonus arrangement is not a complex matter. A simple document that details the benefits, participation requirements, restrictions, and general provisions is required. In addition, applications and associated paperwork to obtain the insurance policies will also be required.

Restricted executive bonus arrangement (REBA)

The employee still owns the permanent life insurance policy and the business pays the bonus for the premiums. However, the difference is this type of policy contains a special endorsement, which requires the employee to obtain the employer's consent to borrow or withdraw cash value, surrender the policy, collaterally assign the policy for a loan, or change the ownership of the policy. This special endorsement does not give businesses any form of ownership, therefore still allowing them to deduct the bonus. The REBA will usually stipulate when these restrictions will be lifted. It could be upon retirement or disability, at a certain age, or once a waiver and release has been signed by the employer. Typically, the business will enter into a separate agreement with the employee that outlines what would happen if the employee terminates their employment with the business before retirement. It may require the employee to pay back all, or a portion of, the bonuses received. Once the restricted period has ended, the business must send a written statement to the life insurance company to lift the special endorsement on the policy.



Some businesses may want to maintain more control over the executive bonus arrangement they enter into with an employee. A REBA establishes some limitations for the employee while they are still employed.

In summary

An executive bonus arrangement can be an effective yet simple tool, which successful business owners can use to recruit, reward, and retain exceptional executives. By implementing a strategic solution that provides incentive rewards to those executives who stay with the business, business owners can reduce the likelihood that a key executive will leave, potentially impacting the business negatively.

Executive bonus arrangement fact finder

Employee

Name ____________________

Annual compensation $ __________ Effective income tax rate (including federal, state, and local taxes) %________

Company ownership (if any) %____________________

Employer

Name ____________________

Address ____________________

Entity type: ☐ C Corporation ☐ S Corporation ☐ Partnership ☐ LLC Other: __________

Effective income tax rate (including federal, state, and local taxes) %____________________

Total Number of Employees ____________________

Illustration

Product to illustrate ____________________

Index accounts: Account name ____________________

Insured's DOB __________ State of policy issue ____________________

Gender: ☐ Male ☐ Female

☐ Smoker ☐ Nonsmoker

Assumed Risk Classification: ☐ Preferred Elite ☐ Preferred Plus ☐ Preferred

☐ Non-Tobacco ☐ Preferred Tobacco ☐ Tobacco

☐ Other: ____________________

Desired: Death benefit $__________ or minimum so as not to create a MEC

Death benefit option: Level __________ Increasing with cash value __________ Increasing switching to level ______

Annual insurance premium $ ____________________

Years to pay premium ______________ or to age ____________________

Maximize income from policy at insured's age ______________ for ______________ number of years

If premium is not known, indicate desired cash flow ____________________

Policy cash value at age 100 equal to: ____________________

Endowment at initial face ________ or keep in force until age 10 ________ or cash value equal to $__________

Policy design

Bonus amount: Single ______________________________ Double ______________________________

Pay bonus until: Retirement ______________________________ Specified $______________________________

☐ Restricted executive bonus arrangement (REBA)

Producer information

Producer name ______________________________

Phone no. ______________________________

Email address ______________________________

Date ______________________________

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