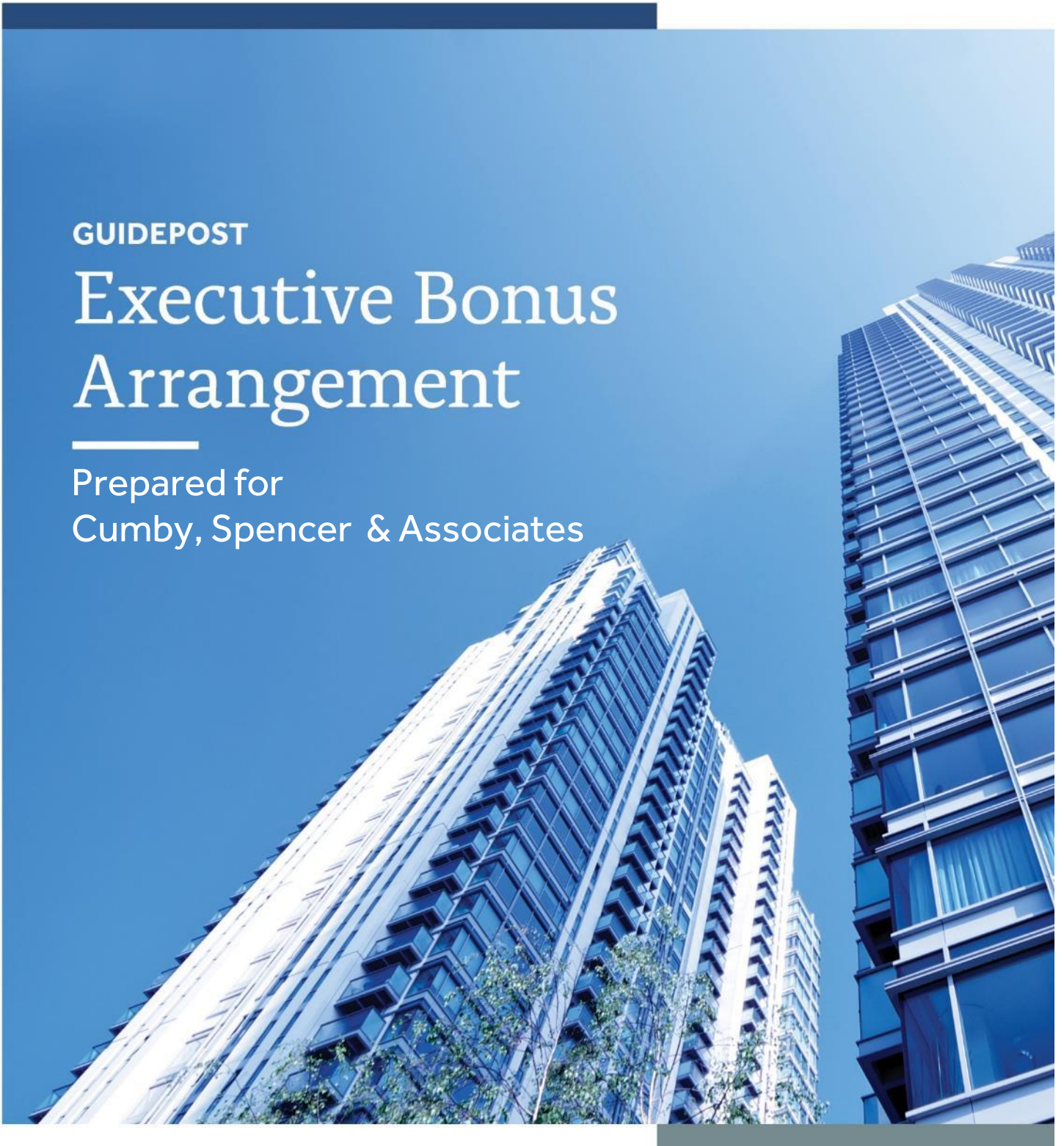


GUIDEPOST

Executive Bonus Arrangement

Prepared for
Cumby, Spencer & Associates



Executive Bonus Arrangement

An executive bonus arrangement, also referred to as a "Section 162 Bonus Plan," is a benefit arrangement in which an employer pays bonus compensation to select employees in the form of premium payments on an employee's personally-owned life insurance policy. An executive bonus arrangement is most easily described as employer-funded personal life insurance. Employers utilize executive bonus arrangements to encourage the employee to remain with the company.

The two basic types of executive bonus arrangements are:

- **Single Bonus** – Employer provides a cash bonus to the employee to allow the employee to purchase a life insurance policy. The employee would be responsible for paying the tax due on the bonus.
- **Double Bonus** - Employer provides a cash bonus to the employee to allow the employee to purchase a life insurance policy and provides an additional bonus to cover the tax due on the bonus amount. A double bonus arrangement is often referred to as a "grossed-up bonus."

In each case, the employee has full ownership rights of the policy including naming the beneficiary and accessing the policy cash values.

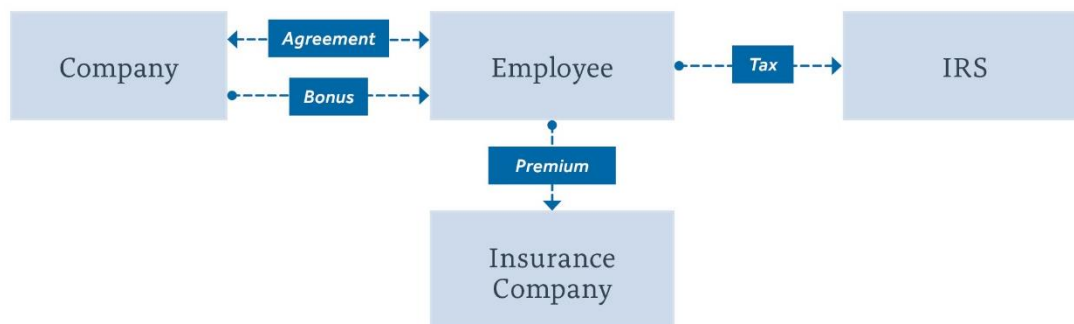
Implementing an Executive Bonus Arrangement

A corporate resolution should be adopted by the employer's board of directors that establishes the purpose for the bonus (for example, to help recruit, retain, and reward key employees), authorizes the company to offer the benefit to key employees, and provides the financial details of the agreement. Although not required, it is advisable to have an attorney formally document the agreement between the employer and the key employee to clearly define the terms of the bonus arrangement.

The employee applies for and owns a permanent life insurance policy on his/her life. As the owner of the policy, the employee has the right to name the beneficiary of the policy's death benefit. The employee should not name the employer as beneficiary of the life insurance policy; otherwise, the bonus would not be income tax deductible to the employer.

The employer may pay the premiums on the life insurance policy directly to the life insurance company or it may bonus the premiums to the employee who in turn writes the check to the insurance company.

At retirement, the employee can access the policy cash values through withdrawals and loans in order to provide a tax-free income stream over a period of years. Alternatively, the policy could also remain "intact" to provide valuable survivor protection for the employee's family. Note that policy loans and withdrawals will decrease the cash surrender value and death benefit. Loans also accrue interest on the amount outstanding.



Restricted Executive Bonus Arrangement

A restrictive endorsement could be incorporated into the agreement that requires the company's consent for the employee to access the policy cash values, surrender the policy, assign or pledge the policy as collateral for a loan, or change the ownership of the policy until a specified time. This can be used to create "golden handcuffs," providing the employee with additional incentive to remain with the company.

Executive Bonus Tax Considerations

Income Tax Considerations- Employer

The compensation bonus is deductible by the employer in the year paid, provided the employee's total compensation is considered reasonable considering the services provided. It is important to document the executive bonus arrangement via a corporate resolution in order to help establish the expense as a business expense of the company to preserve the tax deduction.

Income Tax Considerations- Employee

The cash bonus or premiums paid by the employer are reported as additional compensation on the employee's Form W-2 Wage and Tax Statement in the year in which the bonus is received.

At the employee's death, the life insurance death benefit proceeds are generally received by the employee's designated beneficiary free of federal income taxes.

Estate Tax

If the employee personally owns the life insurance policy, policy death benefits will be included in his/her taxable estate at death. If estate taxes are a concern for the employee, he/she may wish to establish an irrevocable trust to own the life insurance policy. However, if the policy is owned by an irrevocable trust, gift tax issues will need to be addressed.

Executive Bonus Arrangement Compliance Requirements

ERISA Compliance

The Employee Retirement Income Security Act of 1974 (ERISA) was designed to protect the interest of employees in both pension and welfare benefit plans sponsored by their employers. An ERISA welfare benefit plan is generally a plan established or maintained by an employer to provide health, death, or certain other benefits (e.g., accident or disability) to employees. An ERISA pension plan is generally a plan established or maintained by an employer to provide retirement income to employees, or that results in the deferral of income for periods extending to termination of employment and beyond. Both welfare benefit plans and pension plans are subject to ERISA's reporting, disclosure, fiduciary and claims requirements. An ERISA pension plan is also subject to additional rules including eligibility, vesting, funding and coverage requirements.

An executive bonus arrangement may be subject to ERISA depending on different factors. Some of these factors include:

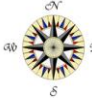
- How many employees are covered under the arrangement;
- Who owns the policy (i.e., the employer or the employee);
- Whether the bonus must be used to pay insurance premiums;
- Whether premiums are paid with employer contributions; and/or
- Whether the policy includes a restrictive endorsement.

If the executive bonus arrangement is subject to ERISA but is structured as a "top-hat" plan, the plan may not be subject to most of ERISA's substantive requirements (e.g., eligibility, fiduciary, vesting, and funding). A top-hat plan is a plan maintained by an employer for a select group of management or highly compensated employees

Section 409A

Section 409A, which governs the timing of when compensation and benefits can be deferred and distributed, was enacted in October 2004 and became generally effective on January 1, 2005. Section 409A applies to compensation earned in one year but that is not paid until a future year. Section 409A generally applies to most nonqualified deferred compensation plans except for Internal Revenue Code (IRC) §457(b) plans, which are exempt from 409A.


Generally, IRC §409A does not apply to executive bonus arrangements.



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Bruce Cumby is the President of Cumby, Spencer & Associates Financial Group. For more than 35 years, he has developed a niche for working with pre- and post-retirement Baby Boomer and business owner clients. Bruce specializes in designing comprehensive, holistic solutions for his client's retirement planning, estate planning, wealth management, and business succession needs, as well as executive and employee compensation and benefits. He focuses on clarifying his clients' goals while creating a road map for their success. He attended St. Joseph's University and earned a Master of Science in Financial Services from the American College.

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Employers should be aware that the arrangements described herein may be subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and Internal Revenue Code Section 409A ("Section 409A"), the tax rule applicable to non-qualified deferred compensation. ERISA imposes certain requirements on employee benefit plans and their sponsors, including but not limited to, fiduciary, disclosure and reporting requirements. These requirements depend on the type of plan ("retirement or welfare plan;" or "top hat retirement" or "top hat welfare plan"). Section 409A imposes certain requirements that, if not satisfied, can result in adverse tax consequences to employees. New York Life Insurance Company and its employees, agents and affiliates do not provide tax or legal advice. Employers should consult with their legal and tax advisors regarding the implications of ERISA and Section 409A on adopting these arrangements in their particular circumstances. This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not provide legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies. © 2018 New York Life Insurance Company. All rights reserved. The Nautilus Group[®] is a service of New York Life Insurance Company. SMRU 1800098 Exp. 07.02.2022