Section 162 Executive Bonus Plan

Providing For Key Employees

With the onerous Deferred Compensation rules contained in Internal Revenue Code Section 409A, 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

In a section 162 Executive Bonus Plan, the employee is the owner of the life insurance policy or non qualified deferred annuity. The employee applies for the policy, is the owner of the policy and names individuals such as a spouse or family members as beneficiary.

The 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. The employer can pay the employee directly or can make the premium payment directly to the life insurance or annuity company.

The employer must determine what they are trying to accomplish with an Executive Bonus Plan when creating and designing a 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. Where 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. If the company wishes to use the section 162 Executive Bonus Plan as a way to not only retain key employees but also as a "golden handcuff", 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 or 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).

Advantages to 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

Advantages to 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

Ordinary income tax may be assessed on any withdrawal. A federal tax penalty of 10% may be assessed on any withdrawals made prior to age 59½.

Disadvantages

- Executive Bonus Plan offers very little control of policy to company
- Key Executive must include bonus in his/her taxable income
- If annuity used, may pay an IRS penalty of 10% on withdrawals from annuities prior to age 59½
- Withdrawals from a life insurance policy will impact cash value and death benefit

A section 162 Executive Bonus Plan is a win-win situation in that the company normally gets to deduct the amount of the bonus and the employee receives an additional benefit. The employer can discriminate as to who can benefit from the program and can provide different levels of benefits to each executive. This is a way to selectively reward and retain key executives while providing the employer with a flexible program. The employer can also use a section 162 Executive Bonus Plan as a "Golden Handcuff" to retain such key executives.

If you have key employees you wish to benefit to the exclusion of other employees, the section 162 Executive Bonus Plan may be appropriate for your company. Contact your financial and tax advisors to determine if a bonus plan is right for you and your company. All concepts, strategies and products discussed in this literature may not be suitable for you and your company. Please consult your advisors to determine which strategy is right for your specific circumstances.

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