EXECUTIVE BONUS PLAN WITH A TWIST

In today's increasingly competitive business environment, finding a cost-effective way to reward key employees can be challenging. An executive bonus plan (EBP) is often the vehicle of choice for rewarding employees because of its simplicity and current income tax deductibility. The primary objection to an EBP is that the employee can leave the employer at any point and take the benefit accrued without any restrictions. However, by adding a twist to the EBP, an employer can potentially create a "golden handcuff" tying the employee to the company.

WHAT IS AN EBP WITH A TWIST?

The basic EBP is a nonqualified benefits program to recruit, reward and retain key talent. The employer pays all or part of the premium on a life insurance policy for a key employee under a "bonus" arrangement. The key employee is the insured and the owner of the policy. The plan offers the key employee immediate death benefit protection, tax-deferred growth of policy values and a potential source of tax-free retirement income in the future. The *twist* comes in when the employer enters into an additional arrangement to loan the employee their annual income tax outlay on the premium bonus plus accrued interest. A collateral assignment on the policy secures the loan arrangement and provides a "golden handcuff" on the employee.

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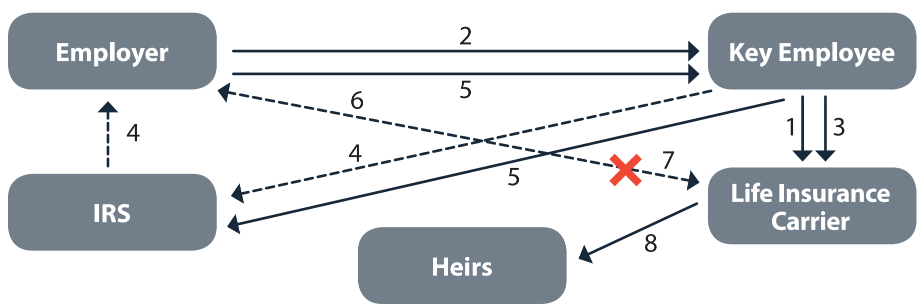
HOW DOES IT WORK?



1. Key employee applies for a life insurance policy on their life.
2. Employer bonuses an amount equal to the premium to the key employee.
3. Key employee pays the premium to the life insurance carrier.
4. Key employee recognizes income equal to premiums paid, and the employer gets a compensation deduction for the same amount under IRC §162.
5. Employer loans employee amount equal to employee's tax on annual premium bonus and employee pays IRS income tax due with the loan proceeds.
6. A collateral assignment is placed on the policy with the carrier equal to cumulative income tax loaned to the employee.
7. At some future time, the loan is repaid from policy values, or the employer may elect to bonus the cumulative loan and the collateral assignment is released.* (If the employee terminates employment prior to the specified date, s/he repays the loan from policy values or outside funds.)
8. At the employee's death, the life insurance death benefit proceeds may be paid to the employee's heirs income tax-free.**

BENEFITS TO KEY EMPLOYEE

- The employee owns a portable life insurance policy.
- The employee has no out-of-pocket outlay.
- Pre-retirement, the employee enjoys tax-free death benefit protection for their heirs.
- Policy cash value grows on a tax-deferred basis and can be accessed to supplement retirement or other income needs.

BENEFITS TO EMPLOYER

- The program provides a method to recruit, reward and retain key talent.
- The employer has the freedom to select participants.
- Bonuses are tax-deductible, as long as the employee's total compensation package is "reasonable."
- The annual loan provides a "golden handcuff" on the employee and is secured by the collateral assignment on the policy.
- There's no impact on existing plans.
- IRS approval isn't required; this program avoids most of the cost and administrative requirements associated with establishing a qualified plan under ERISA.
- EBPs can be less expensive to set up and administer than nonqualified deferred compensation plans.
- The program provides an attractive employee benefits program for a pass-through business entity, where employee deferrals would be taxable to the business owners or for a not-for-profit company where deferral plans are limited under I.R.C. § 457.

CONSIDERATIONS FOR THE EMPLOYEE

Unless additional planning is done, the death benefit of the life insurance policy will be included in the key employee's estate.

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The employer bonuses should be discretionary. Any understanding to pay bonuses, either contractual or implied, could subject the arrangement to IRC § 409A, as a deferred compensation plan.

THE BOTTOM LINE

An EBP with a twist is an attractive option for rewarding a business's most productive employees in a way that's flexible, cost effective and simple to administer. An EBP can provide significant death benefits and tax-advantaged cash value accumulation for key employees, allowing them to meet their personal financial goals.

*There should not be a promise to bonus the cumulative loan to the employee in order to avoid subjecting the plan to the deferred compensation rules under IRC § 409A.

**For federal income tax purposes, life insurance death benefits are generally paid income tax-free to beneficiaries pursuant to IRC § 101(a)(1).