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Executive Bonus: A Deductible Fringe Benefit for Select Executives

Do you have business prospects that would like to provide a retirement benefit for their key executives, but do not want, or cannot afford, to provide retirement benefits for all employees? Do the business owners want the business to receive an income tax deduction? Do the key executives also have a need for life insurance, such as to provide survivor income to a spouse or other heirs? If so, the executive bonus arrangement should be considered.

What Is An Executive Bonus Arrangement?

An Executive Bonus Arrangement is a way for an employer to provide needed life insurance to a selected key employee and get an income tax deduction for doing so. Although the premiums paid by the employer are taxable to the key employee, the company can pay a double bonus to cover the employee's income tax liability. Alternatively, the employee can access the policy values to pay the tax.[1] Meanwhile, the life insurance policy builds cash value on a tax-deferred basis that can be accessed in the future by the executive to help supplement his/her retirement or help with cash needs.

Example of How an Executive Bonus Arrangement Works

Robert and Jane own a local chain of convenience stores. The stores have a large number of full-time employees earning just over minimum wage. Their son-in-law, Burk, runs the day-to-day corporate operations. Burk has come to them with his concerns about immediate protection for his family, should something happen to him, as well as his need for retirement savings. He wants to know if the business would consider sponsoring a qualified plan.

Robert and Jane would like to provide Burk a retirement benefit, but they are reluctant to put a qualified plan in place due to the administrative burden. They would like to reward Burk for his leadership and to protect his family in case something should happen to him. And they would like to make their contributions tax deductible. Their financial representative points out that Robert and Jane's objectives can be met with an Executive Bonus Arrangement.

With an Executive Bonus Arrangement the business and employee enter into an agreement whereby the business agrees either to pay the premiums directly to the insurance company or to pay a cash bonus to the employee sufficient to allow the employee to pay the premiums. The employee is the owner of the life insurance policy, naming someone other than the business as the beneficiary. The company is free to select employees to receive benefits and is not bound by participation and vesting requirements that govern qualified plans. The premium payment is taxable as income to the employee and tax deductible to the business as long as the executive's total compensation is considered reasonable.

* Not in the practice of law

Benefits of an Executive Bonus Agreement

For the Employer:

- Employer can pick and choose which of its employees should be allowed to participate.
- Bonus is tax deductible if compensation is reasonable.
- No IRS approval is required.
- Bonus levels can vary from employee to employee.
- Arrangement can be terminated at any time.
- It is easy to implement with minimal administration.
- Agreement serves as an incentive for participating employees to stay with the company since future bonuses are contingent on employee continuing to work for the firm.

For the Employee:

- Executive is able to buy life insurance protection (with long-term care rider if desired) at a lower out-of-pocket cost than if he/she were to purchase the insurance on his/her own. Out-ofpocket costs can be eliminated if the employer provides a "double bonus" (enough to pay the premium plus the income tax due on the bonus).
- The policy is portable and can provide life insurance/long-term care coverage before and after retirement.
- Policy cash values may be accessed to provide tax-favored supplemental retirement income.[1]
- At the executive's death, cash is available to replace the executive's income to his/her family, to help liquidate debts, and/or to pay estate taxes and administration costs.

How Can DBS Help?

To see how an Executive Bonus Arrangement can help your clients contact your dedicated DBS Case Design Analyst.

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[1] Life insurance policy cash values are accessed through withdrawals and/or policy loans. Loans are at interest. Unpaid loans and/or withdrawals cause a reduction in policy cash values and death benefits and may affect any policy guarantees against lapse. In general, loans are not taxable, but withdrawals are taxable to the extent they exceed basis in the contract. Loans outstanding at policy lapse or surrender occurring prior to the death of the insured and that exceed the policy's cost basis will cause immediate taxation to the extent of gain in the contract. For policies that are Modified Endowment Contracts, distributions (including loans and withdrawals) will be taxed to the extent of policy earnings. There may be an additional 10% federal income tax penalty for taxable distributions prior to age 59½. Consult your tax advisor for advice regarding your particular situation. A policy's illustrated cash value consists of both guaranteed and nonguaranteed values. Nonguaranteed values may include dividends or earnings, which are not guaranteed and will change.

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