John Hancock
LIFE INSURANCE

Sales Strategy

Restricted Endorsement Bonus Arrangements

A WAY TO RETAIN AND REWARD KEY EMPLOYEES

It can be very challenging for businesses to develop executive benefit plans to attract and reward key employees, particularly for small, closely held businesses or S-Corporations. These employers may at first be attracted to profit sharing or 401(k) plans because of the tax benefits, but may dislike the strict participation and non-discrimination requirements of qualified plans. Non-qualified plans such as Salary Deferral Plans or Supplemental Executive Retirement Plans (SERPs) allow employers to reward key employees in a discriminatory fashion, and are easier to administer than qualified plans. However, they do not always work well for S-Corporations or small businesses, in part because the business will not receive a tax deduction until the benefit is actually paid out, but also because they still require plan documents, ongoing administration, and new regulation under Section 409A. Executive Bonus Plans are simple to administer and provide an employer tax deduction, but are not very effective in creating "Golden Handcuff" incentives to retain important executives.

Fortunately, there is another good option. A Restricted Endorsement Bonus Arrangement (REBA) can offer businesses a benefit plan that is tax-deductible, easy to administer, and creates "Golden Handcuffs."

WHAT IS A REBA?

A REBA is an arrangement in which the employer pays a bonus to a key executive by paying the annual premium on a life insurance policy for the executive. The executive will be the insured and owner of the policy, having the right to name the beneficiaries and enjoying any potential policy cash value. A vesting schedule will be applied to the bonus, and the executive's access to the cash value will be restricted until the executive is fully vested.

HOW DOES IT WORK?

The employer decides which executives to include in the plan, and these executives apply for life insurance on their lives. The executives will own the policies, including the policy cash value and the right to name the beneficiary of the death benefit. Then, the employer and employee execute a "restricted endorsement" at the time the policy is purchased and file it with the life insurance company. Although the executive will be the owner of the policy, the endorsement will keep the executive from accessing the policy cash value until retirement or vesting. Typically, the endorsement prevents the employee from:

- surrendering the policy for its cash value,
- making cash withdrawals from the policy,
- borrowing against the policy's cash value,
- assigning or pledging the policy as collateral, and
- changing the ownership of the policy until retirement or a specified period of time.

The employer will then pay the premium for the life insurance policy on the executive in the form of a bonus. The employer receives an income tax deduction for the bonus as it vests, while the executive pays the taxes on the bonus amounts as they vest.[1] The employer could elect to increase the bonus to cover the executive's tax cost ("double-bonus"), which would result in the executive having no out-of-pocket costs. Employers often use a double-bonus approach with REBAs because the executive has limited access to the policy cash value and does not like to pay taxes on money that is under restriction.

HOW DOES IT WORK? (continued)

At retirement (or completion of vesting, if earlier), the endorsement is lifted and the executive will be able to use the potential cash value in any way desired, including supplementing retirement income through policy loans and withdrawals. If the employee leaves the company before fully vesting, any unvested portion of the bonus is generally paid back to the employer. If it is sufficient, the policy cash value can be used for this purpose to reduce the executive's out-of-pocket costs.[2]

BENEFITS

FOR THE EMPLOYEE

- *Portable, Low-cost Life Insurance.* The executive is the owner of the policy and can take it with him or her on leaving the company. Because the employer pays the premium, the executive's only cost is the tax on the bonus, or even no cost at all if the employer provides a double-bonus.
- *Tax-free Death Benefit and Tax-deferred Cash Value Accumulation.* The executive owns the policy and can name the beneficiaries, who will receive the life insurance proceeds income tax free. Additionally, during the executive's lifetime the policy cash value will grow on a tax-deferred basis.
- *Policy Cash Value can Serve as Source of Supplemental Retirement Income.* Because the restricted endorsement will be removed from the policy at or prior to the employee's retirement, the executive can use it for supplemental retirement income. Withdrawals from the policy can be made on an income tax-free basis up to cost basis. Policy loans can also be taken without income tax consequences.[3]
- *Not Subject to Qualified Plan and Penalty Tax Provisions.* Qualified retirement plans are subject to restrictions on the amount of money that can be contributed by (or on behalf of) an employee. When distributions are taken from a qualified plan, they may be subject to certain penalties, such as the 10% penalty tax on early (prior to age 59½) withdrawals. A REBA is not a qualified plan. After the restricted endorsement is removed, access to the policy's cash value (by withdrawal up to basis or by loan) is not ordinarily subject to income or penalty taxes.

FOR THE EMPLOYER

- *Distinguishes Employer's Compensation Package.* A REBA adds an enticing benefit for the participating executive by offering low-cost life insurance policy ownership.
- *Selective Participation and Discrimination Allowed.* Because a REBA is not a qualified plan, the employer may choose which employees will participate in the plan, and even reward them all at different levels. For instance, the employer could offer a double-bonus and a five-year vesting schedule to one employee, while giving another only a single-bonus and a 10-year vesting schedule, based on which executive the employer wishes to reward more.
- *Vesting Schedule and Cost Recovery.* The employer can impose a vesting schedule and require employees to pay back the unvested portion of the bonus if they leave the company before fully vesting.
- *Tax Deductible.* The employer may deduct the vested portion of the bonus, as soon as vesting occurs. This is true even in S-Corporations, Partnerships, and Sole Proprietorships, when the plan participants are generally non-owner employees.
- *Minimal Set-up Fees and Limited Annual Administration Costs.* The primary expense of establishing a REBA is the cost of preparing the REBA agreement. This makes the cost of establishing a REBA much less than the cost of establishing a qualified plan. A REBA can also be less expensive to set up than many types of non-qualified deferred compensation plans. Once established, only minimal annual reports or administration are needed for a REBA. The ERISA implications of REBAs are discussed on page 4.

A solution for both
employer and employee.

CONSIDERATIONS

- ***Section 61 Taxation.*** Premium payments made by the employer are generally believed to be compensation to the employee under IRC Section 61.[4] Therefore, subject to "reasonable compensation" limitations, the likely tax treatment should be current income for the employee equal to the vested portion of the premium paid, and a corresponding current deduction for the employer.[5] When a double-bonus arrangement is utilized, the employer will also bonus the employee an amount necessary to cover the employee's income tax liability. This additional bonus should also be subject to current income taxation.
- ***ERISA Implications.*** Title 1 of ERISA covers all employee benefit plans and divides them into welfare plans and pension plans. To be covered by ERISA, there must be a "plan." If a REBA is a negotiated arrangement between an employer and a single employee, there is a strong argument that there is no "plan" and ERISA does not govern the arrangement. However, if there are multiple employees covered by REBAs, it is more likely that there is a "plan" for ERISA purposes. In the event that a REBA is considered a "plan," it may qualify as a "top hat" plan if it only covers select management or "highly compensated" employees. ERISA reporting requirements for "top hat" plans are limited.[6] Whether a REBA is subject to ERISA must be determined on a case-by-case basis.
- ***Section 409A.*** Although simpler than a Salary Deferral Plan or SERP, a REBA must still comply with the provisions of Section 409A of the Internal Revenue Code, and the applicable regulations. As a REBA is a non-elective deferral, and the employee pays taxes on the bonus as soon as it vests, complying with the provisions of 409A should not be difficult. However, clients should consult their legal, tax, and accounting advisors to make sure they are in compliance.

CASE STUDY: SAYER TRAVEL AND CHARLIE ALLNUT

Sayer Travel is a successful travel company that arranges safaris and river trips in Africa. Its owner and CEO is Rose Sayer. Last year, Rose hired Charlie Allnut away from her main competitor. Charlie is an experienced guide and river man who has been very popular with the tourists. Now that Rose has acquired Charlie, she would like him to stay with Sayer Travel for a long time. Rose decides to implement a REBA. Although Rose has many employees, only Charlie will participate in the plan because he is the only employee she is anxious to reward. Charlie will apply for an $886,319 Accumulation UL policy on his life,[7] with an increasing death benefit and an initial premium of $50,000. Rose will double-bonus him $55,385 in year one, so at Charlie's tax bracket of 35%, he will have enough to pay both the premium and the taxes with no out-of-pocket costs to himself. Charlie and Sayer Travel will execute a restricted endorsement with a five-year rolling vesting schedule and file it with the insurance company. Sayer Travel will get to deduct the bonus and enjoy a tax savings of $6,152 at its 40% tax bracket. Charlie will own the policy and enjoy the death benefit protection for his family, as well as any potential policy cash values. As long as he stays with Sayer Travel, Rose agrees to pay the double-bonus. If Charlie stays until retirement, he has access to the policy cash value in the form of loans and withdrawals to supplement his retirement income.

YEAR	BONUS*	TAX DUE	PREMIUM	LOANS AND WITHDRAWALS	CASH SURRENDER VALUE (5.50% net)	DEATH BENEFIT	EMPLOYER TAX SAVINGS
1	$55,385	$5,385	$50,000	$0	$23,000	$931,755	$6,152
5	$76,923	$26,923	$50,000	$0	$241,310	$1,140,094	$30,769
10	$76,923	$26,923	$50,000	$0	$587,431	$1,473,750	$30,769
20	$76,923	$26,923	$50,000	$0	$1,647,296	$1,976,756	$30,769
25	$0	$0	$0	$124,385	$1,428,297	$1,642,542	$0
30	$0	$0	$0	$124,385	$1,135,910	$1,205,962	$0
40	$0	$0	$0	$124,385	$216,964	$336,676	$0

*Double-bonus amounts and corresponding employer tax deductions will increase over time as Charlie vests in a greater proportion of the premiums paid.

The data shown is taken from an illustration. It assumes a hypothetical rate of return and is not a representation of expected future results. Unless indicated otherwise, these values are not guaranteed.

CASE STUDY: SAYER TRAVEL AND CHARLIE ALLNUT (continued)

Now let's assume that Charlie decides to leave Sayer Travel in year 11. According to the vesting schedule, he must pay back $100,000 of the bonus. Based on the current interest rate and current cost of insurance charges, Charlie can withdraw the $100,000 from the policy, stop paying premiums, and still enjoy some supplemental retirement income.

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1	$55,385	$5,385	$50,000	$0	$23,000	$931,755	$6,152
5	$76,923	$26,923	$50,000	$0	$241,310	$1,140,094	$30,769
10	$76,923	$26,923	$50,000	$0	$587,431	$1,473,750	$30,769
11	-$100,000	$0	$0	$100,000	$513,824	$1,373,750	$0
20	$0	$0	$0	$0	$829,405	$1,373,750	$0
25	$0	$0	$0	$61,172	$723,174	$1,067,890	$0
30	$0	$0	$0	$61,172	$575,410	$733,037	$0
40	$0	$0	$0	$61,172	$126,476	$195,987	$0

The data shown is taken from an illustration. It assumes a hypothetical rate of return and is not a representation of expected future results. Unless indicated otherwise, these values are not guaranteed.

As demonstrated above, the plan will provide benefits to both Rose and Charlie. Rose has a tax-deductible benefit that she can use to show Charlie how much she values his contributions and encourage him to stay with Sayer Travel. Charlie will enjoy the death benefit protection and potential policy cash values with minimal cost to himself, because of the bonus from Sayer Travel.

CONCLUSION

A REBA is a simple, tax-deductible way for an employer to recruit, reward, and retain the people who matter the most to the company. The employer enjoys the ability to provide a "Golden Handcuffs" benefit plan for a select group of employees. The employees enjoy low-cost life insurance death benefit protection and access to potential supplemental retirement income. With a REBA, both employer and employee win.

For additional information, please contact your local John Hancock Representative or call the Advanced Markets Group at 888-266-7498, option 3.

This material does not constitute tax, legal, or accounting advice, and neither John Hancock nor any of its agents, employees, or registered representatives are in the business of offering such advice. It cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

1. The amount of the bonus that the employer is able to deduct is subject to reasonable compensation limits. Clients should consult their tax advisors.
2. Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½.
3. There can be income tax consequences upon the transfer, surrender, or lapse of a policy subject to loans. These tax consequences are not addressed in this Sales Strategy.
4. See Treas. Reg. §1.61.2(d)(2)(ii)(a) ("Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee.")
5. IRC Section 162 provides an income tax deduction for "ordinary and necessary" business expenses, including reasonable compensation (up to $1,000,000 per employee). However, IRC Section 264 provides that the employer is not entitled to a deduction when the employer is directly or indirectly a beneficiary of the insurance policy. Consult your tax advisors before entering into a REBA.
6. Top hat plans must be in writing and set forth claims procedures and the identity of the plan fiduciary. A statement must be filed with the Department of Labor within 120 days of the adoption of a pension plan that meets the top hat requirements. Plan documents must be made available upon request.
7. Based on Male, Preferred Non Smoker, age 45, living in Maine. Annual premium of $50,000 will be paid for 20 years. At the current rate of 5.50% and current mortality charges, the initial increasing face amount is $886,319 and will remain in force until age 100.

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