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EMPLOYER GUIDE

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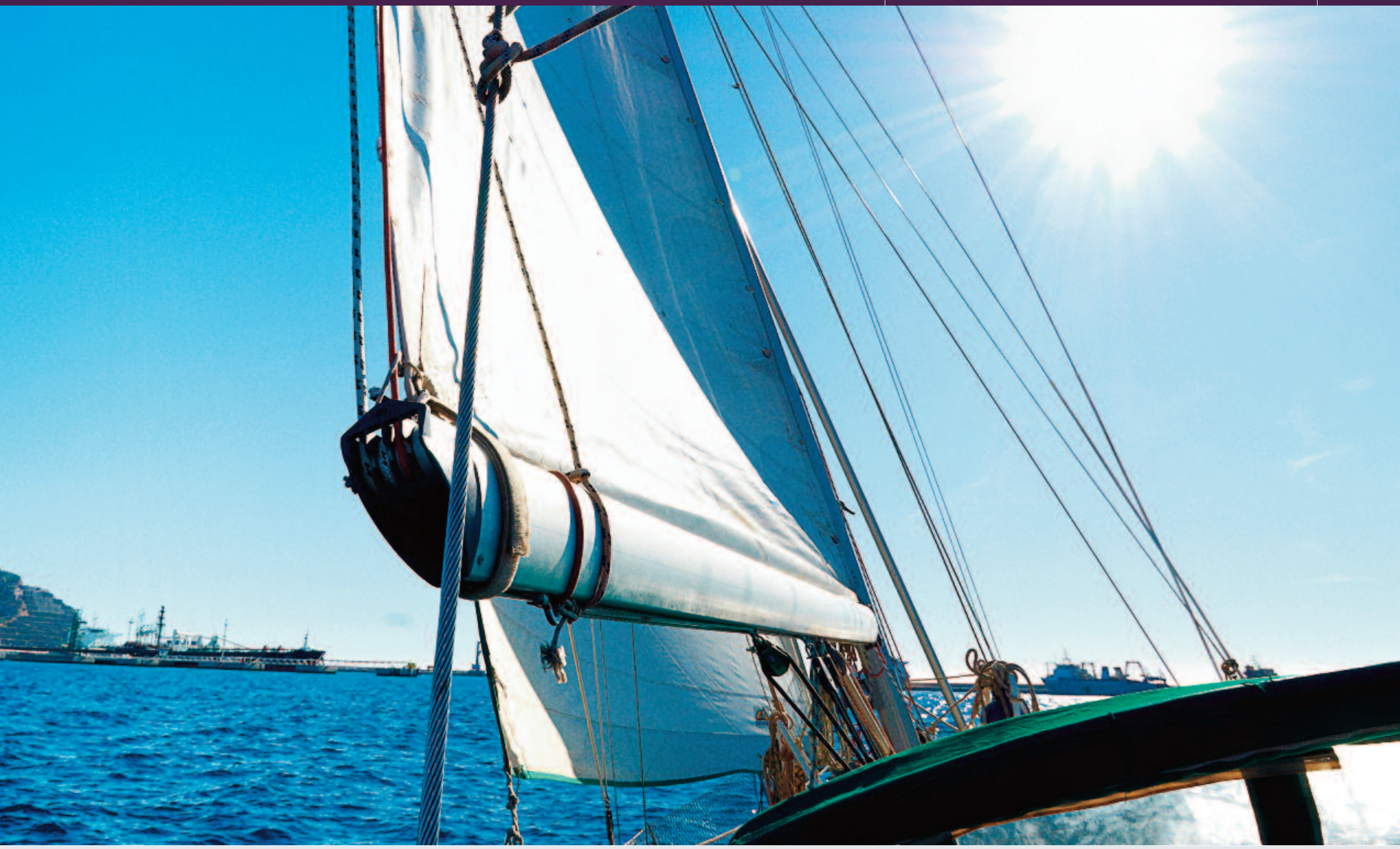

Executive Bonus Plans and Restricted Endorsement Bonus Arrangements

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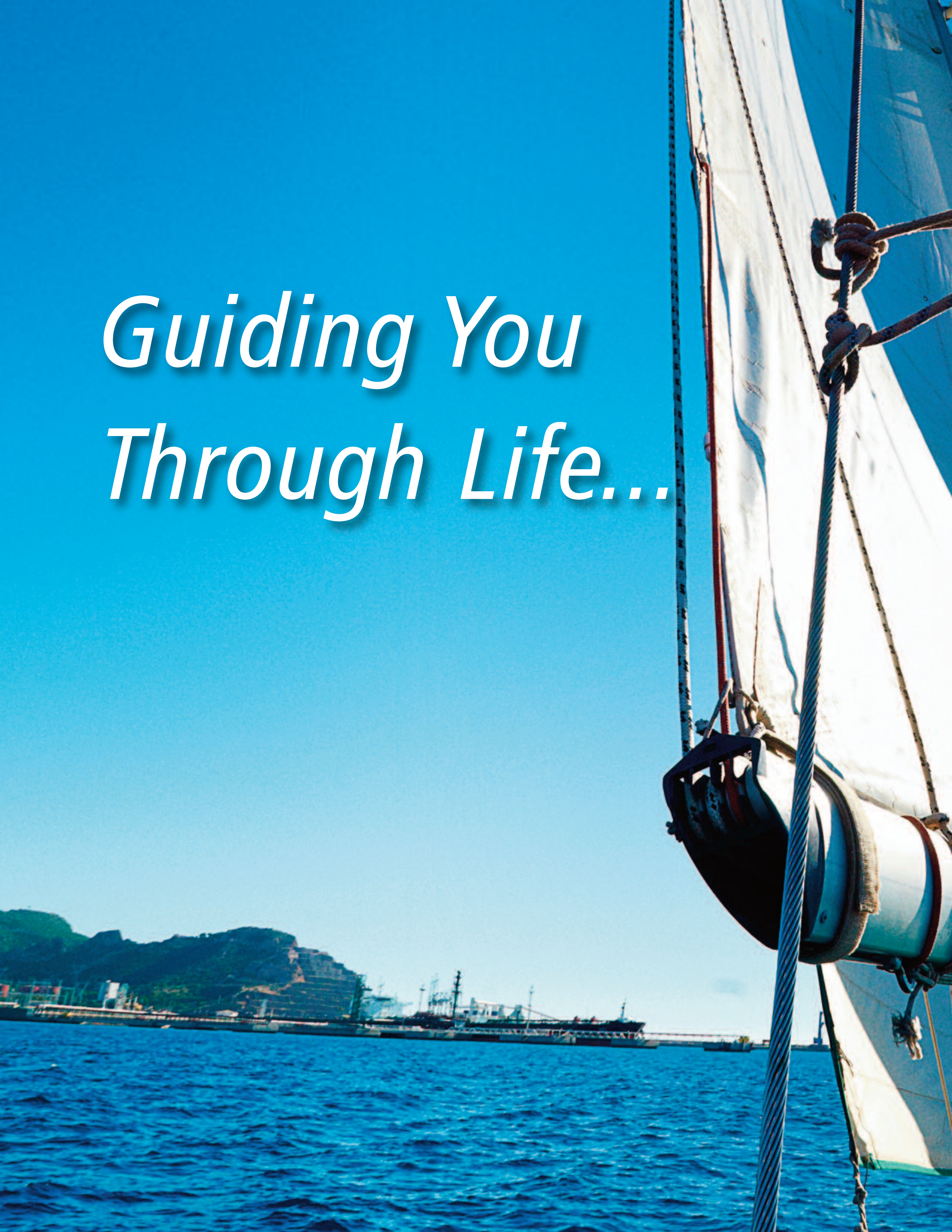
Guiding You
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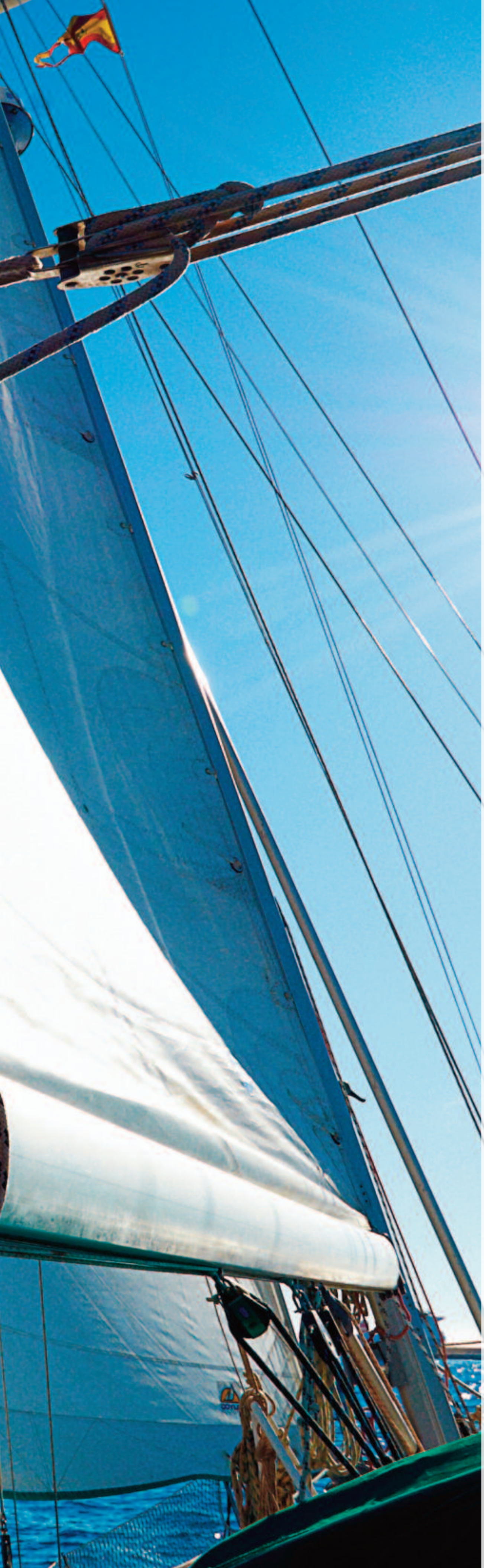

Executive Bonus Plans and Restricted Endorsement Bonus Arrangements (REBAs)

In today's competitive environment, it is hard for companies to attract, retain, and reward talented executives, and finding a cost-effective way to reward your key employees can be challenging. Qualified plans have preferential tax treatment, but you must include all employees and reward everyone to the same degree, regardless of the benefit they bring to your company. Additionally, qualified plans have strict administration requirements that add to the cost and inconvenience. Non-Qualified Salary Deferral Plans and Supplemental Executive Retirement Plans (SERPs) allow you to reward key employees in a discriminatory fashion, and are easier to administer than qualified plans. However, they still require plan documents and ongoing administration, and they also face regulations from Section 409A of the tax code. So, how can you reward your most productive employees in a way that is flexible, cost-effective, and simple to administer?

Two plans may be able to help.

Executive Bonus Plans and Restricted Endorsement Bonus Arrangements (REBAs) are both appealing to your key employees, and offer you a plan that is simple to implement and administer.

Executive Bonus Plan

An Executive Bonus Plan (also known as a "162 Bonus Plan") is an arrangement in which you pay a bonus to an executive by paying the annual premium on a life insurance policy for the executive. The executive will be the owner of the policy and he or she has the right to name the beneficiaries of the policy. The executive will also own any potential policy cash value and will be able to access it at retirement via tax-favored loans and withdrawals.[1]

How It Works

First, determine which employees you would like to include in the plan, as well as the amount of bonus each employee should receive. You may pick and choose among your most valuable employees, and reward each employee at a different level. Then, you will enter into a separate agreement with each employee, promising to pay the life insurance policy premium via a bonus as long as the employee remains with the company. The bonus will be tax deductible to you as long as it meets reasonable compensation guidelines.[2]

Next, the executive will apply for a life insurance policy on his or her own life, and retain all rights of ownership in the policy, including access to the policy cash value and the right to name the beneficiary of the death benefit. You will pay the life insurance premium on the executive's behalf, and include this amount as a bonus in the executive's taxable compensation. The executive will be responsible for paying the income tax due on the bonus, however, you also have the option to increase the bonus amount to cover the executive's taxes. This approach is called a "double bonus". You can discriminate among employees, providing a double bonus for some and not others, if desired.

Pre-retirement, the executive enjoys cost-effective death benefit protection for his or her family, since the only outlay required of the executive will be the tax on the bonus, or even no cost if you elect to provide a double bonus. The life insurance policy cash value (owned by the executive without restrictions) will grow on a tax-deferred basis. At retirement, the executive may be able to use the potential cash value in any way desired, including supplementing retirement income through policy loans and withdrawals.

BENEFITS OF EXECUTIVE BONUS PLANS
For You
Selective participation allowed
Discriminatory benefits allowed
May receive immediate tax deduction
Simple to install
Minimal cost to implement
For Your Key Employees
Low-cost life insurance
Immediate vesting
Executive can name policy beneficiary
Potential cash value source of supplemental retirement income

Considerations

Unlike other non-qualified benefit plans such as Salary Deferral Plans or SERPs, the employer cannot recover the cost of the bonus from either the policy death benefit or cash value, as the employee is the sole owner of the policy. Additionally, while the employee has an incentive to stay with your company in order to continue to receive the premium bonus, the employee is fully vested in the bonuses already paid and does not have to repay any amount should he or she decide to leave. If you wish to add a more vigorous vesting schedule as an incentive for your key employees to stay with the company, you may wish to consider a REBA.

Restricted Endorsement Bonus Arrangement (REBA)

A REBA is simply a more specialized form of an Executive Bonus Plan. As with the Executive Bonus Plan, you pay a bonus to an executive by paying the annual premium on a life insurance policy for the executive. The executive will be the owner of the policy and has the right to name the beneficiaries. However, with a REBA, a vesting schedule will be applied to the bonus and the executive's access to the cash value will be restricted until the executive vests fully, this is commonly referred to the "golden handcuffs," because it gives the employee incentive to stay with your company.

How It Works

As with the Executive Bonus Plan, first you will choose which employees will participate in the plan and how much of a bonus each employee will receive. Then, the executive will apply for life insurance on his or her life. You and the executive will execute a "restricted endorsement" at the time the policy is purchased and file it with the life insurance company. The endorsement can impose a vesting schedule and restrict the employee's access to the policy cash value until a date agreed upon in the endorsement. You may give each executive in the plan a different vesting schedule, if desired, or even have some executives not subject to a vesting schedule at all.

Your company will pay the premium for the life insurance policy on the executive in the form of a bonus. You will only receive an immediate income tax deduction for the vested portion of the bonus (each time a bonus "vests" you will then get additional income tax deduction for the vested portion). In addition, the executive pays the taxes on the vested bonus amount. Because of the restrictions placed on a REBA, it is common for employers to elect to increase the bonus to cover the executive's tax cost (they can "double bonus" the premium).

Should the executive leave the company before he or she has fully vested, 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. Typically when the endorsement is lifted, the executive will be able to use the potential cash value in any way desired, including supplementing retirement income through policy loans and withdrawals.

BENEFITS OF REBA

For You

- Selective participation allowed
- Discriminatory benefits allowed
- May impose a vesting schedule and recover costs if employee leaves before vesting
- May receive tax deduction as bonus vests
- Simple to install
- Minimal cost to implement

For Your Key Employees

- Low-cost life insurance
- Executive can name policy beneficiary
- After vesting, may use the potential cash value as a source of supplemental retirement income

Considerations

A REBA is more complicated than an Executive Bonus Plan and requires that a restricted endorsement be filed with the insurance company. Furthermore, as the employer, you will only receive a deduction for the bonus paid to the employee as it vests, rather than when the premium is paid. Some plan administration will be needed to track the vested and unvested portion of the bonus.

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 Section 409A should not be difficult. However, you should consult your legal, tax, and accounting advisors to make sure you are in compliance.

1. 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.
2. The amount of the bonus that the employer is able to deduct is subject to reasonable compensation limits. A detailed discussion of this is beyond the scope of this document. Clients should consult their tax advisors.

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