An Executive Bonus Plan

Since salary alone is often not enough, what steps can your business take to retain your key employees?

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Problems When a Key Employee Terminates Employment

Does Your Business Have Any Key Employees?

Most successful businesses have one or more key employees who are primarily responsible for the success of the business. When one of these key people terminates employment, the business can experience one or more of these problems:

Reduction in Earnings	Are significant portions of business sales or receipts attributable to a few key people?
Disruption of Management	Is business management concentrated in the hands of a select few key people?
Replacement Costs	How much would it cost to recruit, hire and train a replacement for a key employee?
Credit Problems	How will your creditors react to the loss of a key employee?
Confidence Problems	How will your customers, suppliers and other employees react to the loss of a key employee?
Competition	Will the former employee establish a competing business?

An Executive Bonus Plan Solution

Reward selected key employees with a valuable tax-deductible, employer-provided fringe benefit that they will lose if they terminate employment.

With an executive bonus plan, your business pays a bonus to **selected key employees** in the form of **tax-deductible life insurance premiums**. In addition to providing key employees with personal life insurance protection paid for with tax-deductible business dollars, an executive bonus plan offers these advantages:

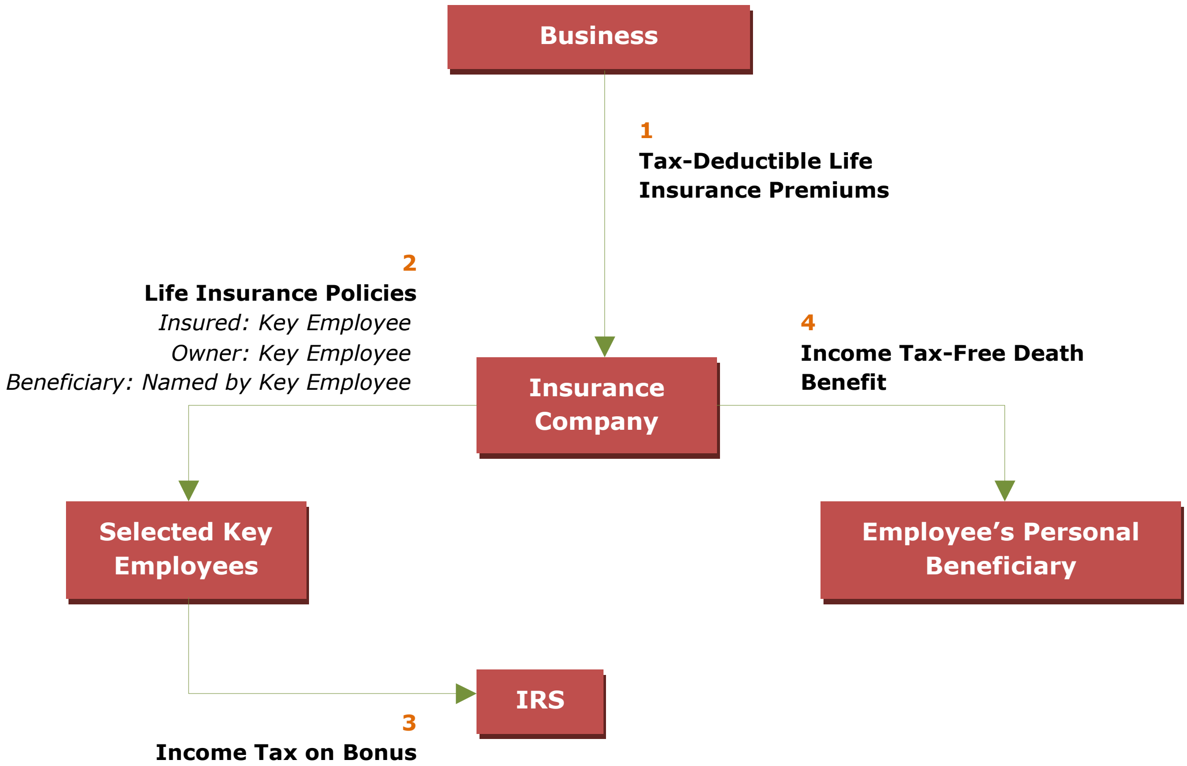
- **The business can select which employees will be covered by the plan and for what amounts.** An executive bonus plan can be used to motivate and retain the key employees of sole proprietorships, partnerships and corporations, as well as to benefit shareholder-employees of a closely-held corporation.
- If they wish, **shareholder-employees of a closely-held corporation** can install an **executive bonus plan for themselves only**, excluding all other employees.
- An executive bonus plan is **simple to implement and administer**, requiring no IRS approval.
- **The business can deduct the executive bonus plan life insurance premiums** it pays as a business expense under Section 162 of the Internal Revenue Code.
- While **covered employees must report the bonus as ordinary income**, they own their policies and **can use any policy dividends or cash values to offset taxes** due on the premium payment.*
- **At retirement**, policy cash values are available to **supplement other sources** of retirement income.*
- Generally, **death benefits are received free of income tax** by the key employee's personal beneficiary and may be structured to avoid estate taxation.

** Withdrawals and loans will reduce the policy's death benefit and cash value available for use.*

The Mechanics of an Executive Bonus Plan

The bottom line is that an executive bonus plan is a simple, effective way to provide personal life insurance to selected key employees, including shareholder-employees, using fully tax-deductible business dollars.

Here's how an executive bonus plan could work to reward and retain your key employees...



1. The business agrees to pay the tax-deductible premiums for life insurance policies applied for by selected key employees.
2. Each of the selected key employees owns the policy on his or her life and names a personal beneficiary for the death benefit. While alive, the key employee controls the policy's cash value and is entitled to any policy dividends paid.
3. The cost to the key employee is the income tax due on the premiums paid by the business as a bonus.
4. At the key employee's death, his or her personal beneficiary receives the death benefit free of income tax.

Executive Bonus Plan Variations

Standard Executive Bonus Plan

The business pays the tax-deductible premiums for the life insurance policy and reports them as a bonus to the selected key employee. The key employee then must pay the income tax due on this additional taxable income.

Double Executive Bonus Plan

The business increases the tax-deductible bonus to cover both the premiums and the income tax due on the total bonus, meaning that the selected key employee has no additional out-of-pocket cost for this valuable employer-provided fringe benefit.

Let's see what the **annual after-tax cost** of these two executive bonus plan variations is for both your business and the key employee...

After-Tax Cost Analysis Example:

Initial Face Amount of Insurance:	$100,000
Initial Annual Premium:	$2,000
Employee's Tax Bracket:	24%
Employer's Tax Bracket:	21%

Standard Executive Bonus Plan		
Employee's Annual After-Tax Cost:	$	480.00
Employer's Annual After-Tax Cost:	$	1,580.00

Double Executive Bonus Plan		
Total Bonus to Employee:	$	2,631.58
For Income Tax on Bonus:	-	631.58
For Annual Premium:	-	2,000.00
Employee's Annual After-Tax Cost:	$	0.00
Employer's Annual After-Tax Cost:	$	2,078.95

NOTE: If the employee is a shareholder-employee of a closely-held corporation, the **combined** annual after-tax cost of the employee **and** employer should be considered in analyzing the cost effectiveness of an executive bonus plan. Generally, an executive bonus plan is cost effective when the corporation is in a **higher** tax bracket than the shareholder-employee.

Summary of Executive Bonus Plan Tax Results

- Premiums are reported as compensation to the employee and are deductible as a business expense by the employer, assuming there is no problem with reasonableness of compensation.

- The only cost to the employee is the income tax on the premiums. Tax-free policy loans can be used by the employee to offset the income tax due. Alternatively, policy dividends or withdrawals from cash value can be made for the same purpose (withdrawals and loans will reduce the policy's death benefit and cash value available for use). Check with your tax advisor as to the tax consequences of loans and withdrawals.

- An executive bonus plan requires no IRS approval. The employer can select the employees who are eligible to benefit from the plan and can discriminate in the amount of premium offered to each key employee.

- As with any personally-owned life insurance, death benefits generally are received free of income tax by the employee's personal beneficiary.

- The death benefit is included in the deceased employee's estate if he or she held any incidents of ownership. If policy ownership is transferred to a third party, such as the spouse, and the three-year rule is satisfied, the proceeds may be removed from the deceased employee's estate. A professional tax advisor should be consulted for more information on estate taxation.

Executive Bonus Plan Action Checklist

Now…

- ☐ Select the key employee(s) to participate in the plan, as well as the premium amounts.
- ☐ Select the appropriate life insurance funding vehicle(s).
- ☐ Establish each key employee’s insurability.
- ☐ Arrange for payment of premiums, entering each premium payment as a cash bonus for accounting purposes.

Short-Term…

- ☐ Draft and execute an executive bonus plan agreement and/or a corporate resolution authorizing the plan, as appropriate.
- ☐ Review the issued policy(ies), verifying that policy ownership and beneficiary designations are correct.

Longer-Term…

- ☐ An annual review can help ensure that the plan remains current.
- ☐ Evaluate other employee benefit planning needs.

Important Information

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