162 Bonus Plans – The Basics for Employers

EXECUTIVE SUMMARY

As the economy improves, employee talent is at a premium. Well designed executive benefit plans are important tools in both retaining and attracting top talent.

One type of executive benefit plan, commonly referred to as a 162 bonus plan, is designed to provide supplemental benefits to select key employees. Generally, the plans use life insurance, funded by the employer's bonus payments, to provide the insured employee with access to policy cash value if needed for retirement or other purposes and death benefit protection for the employee's family. While the employee receives the bonus payments as taxable compensation income, the employer can take a corresponding deduction for the payments. From the employer's perspective, these plans also are typically subject to less complex tax rules and ERISA regulations than other nonqualified deferred compensation plans.

162 bonus plans may make sense for employers looking to attract and retain key employees or provide carve-outs from group-term life insurance programs, particularly for younger key employees in lower tax brackets who likely have insufficient insurance coverage. Employers may appreciate the relative ease of implementing and administering these plans, while employees can benefit from access to cash values if needed for retirement or other purposes and death benefit protection.

WHAT IS A 162 BONUS PLAN?

A 162 bonus plan is an arrangement where the employer effectively funds an employee's purchase of life insurance through the payment of bonuses to the employee or possibly through direct payment to the issuing carrier. The employee acquires and owns all rights in the policy. The employer in a 162 bonus plan does not anticipate reimbursement of any premiums paid, is not a direct or indirect beneficiary of the policy, and never owns an interest in the policy.

WHY USE A 162 BONUS PLAN?

POTENTIAL EMPLOYER BENEFITS

• *Deductibility of Bonus Payments:* The employer generally can take a current deduction for bonus payments under the plan.

• Ease of Implementation/Administration: A 162 bonus plan is relatively easy to implement and administer, especially as compared to other non-qualified employee plans.

• *Administrative Flexibility:* In most instances, a 162 bonus plan is not considered a "qualified plan" under the Code or ERISA, which would require compliance with various nondiscrimination rules. Thus, the employer has significant flexibility to choose the covered key employees, to decide the amount and duration of the bonus, to offer plans with different terms or benefits for various employees, and to vary the types of insurance policies covered.

• *No IRS Consent:* The employer does not need to obtain IRS consent to implement or terminate a 162 bonus plan.

• *Key Employee Retention:* The company may impose certain terms in the plan agreement or restrictions on the policy through a "restrictive endorsement benefit arrangement" or "REBA" to incentivize the employee to remain with the company.

POTENTIAL KEY EMPLOYEE BENEFITS

• *Customizable:* 162 bonus plans can be tailored to the selected employee, based on an employee's individual need for permanent life insurance benefits or post-retirement needs.

• *Management of Income Tax Impact on Employee:* The income tax impact to the employee can be minimized if the employer agrees to "gross-up" the bonus payments to cover the employee's anticipated tax liability thereon.

• *Sole Ownership:* The key employee (or ILIT) will solely own the policy, allowing the employee to control or retain the policy during and after employment, subject to any REBA.

• *Cash Value Growth, Access and Death Benefits:* Under appropriate and long-standing tax laws and principles, the cash value growth within a life insurance policy generally is not subject to income tax and policy beneficiaries receive the policy death benefits imposition to income tax, and possibly without estate tax if the policy is held in an ILIT. Cash value generally can be accessed through policy loans and/or withdrawals (up to policy basis), without imposition of income tax.

TAX IMPLICATIONS

Employee: The bonus is ordinary income to the executive and taxed at his/her normal income tax rate. Any lifetime benefits taken from the policy (e.g., withdrawals or policy loans) are treated and taxed for income tax purposes as if the employee purchased the policy directly. The policy death benefits paid to the policy beneficiaries upon the employee's death should not be subject to income tax.

Employer: Typically, the employer can take an income tax deduction for bonuses paid under the 162 bonus plan, provided the payments constitute compensation to the key employee that, when combined with the employee's other compensation, is reasonable, and the employer is not directly or indirectly a beneficiary of the policy. The bonus is treated as wage income; therefore, it is subject to both FICA and FUTA withholding.

SUMMARY

Fulcrum Partners' consultants are among the most experienced in designing and implementing these plans. Our clients appreciate the relative ease of implementing and administering these plans, while their employees benefit from death benefit protection and access to cash values if needed during retirement.

Fulcrum Partners LLC, is pleased to distribute this AALU Washington Report on the merits and uses of 162 Bonus Plans for employee compensation. This content has been condensed from the original report.

About Fulcrum Partners LLC:

Fulcrum Partners LLC is one of the nation's leading and largest executive benefits consultancy. It's consultants focus on an integrated approach to the design, financing and plan administration of executive benefit programs. Fulcrum Partners offers its clients a unique combination of industry experts with diverse skill sets, targeted experience, and in-depth expertise in executive compensation and benefits consulting. Fulcrum Partners is a wholly independent, member-owned firm dedicated to help clients enhance their Total Rewards Strategy.

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