MassMutual

STRATEGY SPOTLIGHT*

Retaining Key People with Executive Bonus and Leveraged Bonus Arrangements

Finding a cost-effective way to reward key people can be challenging. Qualified plans have preferential tax treatment but an employer must generally include all employees and follow participation and administration requirements. A deferred compensation arrangement reduces some of the participation requirements but still requires plan documents and ongoing administration. An executive bonus arrangement may be the solution to this dilemma. It is an executive compensation strategy that is easy to understand and implement. Furthermore, since an executive bonus arrangement is not an ERISA plan, IRS approval and ERISA filings are not required.

Executive Bonus (and Double Bonus)

An executive bonus arrangement (also known as an Internal Revenue Code [IRC] Sec. 162 plan) is a strategy in which the employer pays a bonus to the executive by paying the premiums on a life insurance policy owned by the executive. This option is named after the IRC section upon which it is based. Whole life insurance with a cash value feature is a key component of an executive bonus arrangement. It can be used to provide benefits to select key people and/or business owners.

Under this arrangement, an employer enters into an agreement with one or more executives to pay (via a bonus) all or part of the premiums for a life insurance policy owned by that executive. The bonus is tax deductible to the employer but is taxable income to the executive. If necessary, an employer can limit an executive's out-of-pocket expenses by bonusing not only an amount equal to the original bonus, but also an amount equal to the taxes due on that amount (commonly called a double bonus arrangement).

* The information provided is not written or intended as specific tax or legal advice. MassMutual, its subsidiaries, employees, and representatives are not authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.

Leveraged Bonus Arrangement

The leveraged bonus arrangement is another twist on the executive bonus arrangement. Instead of the double bonus plan described above, an employer loans the executive the funds needed to pay his taxes that are due on the bonus. The loan is secured by a collateral assignment of the policy cash value (which prevents the executive from accessing the policy cash value while the loan is outstanding), and annual loan interest is paid on the loan based upon a rate equal to or greater than the applicable federal rate (AFR) for the term of the loan that is utilized. The loan is an added incentive that may help to increase retention.

Upon retirement or termination from service, the loan to the executive would become due and payable back to the employer. The loan can be repaid from out-of-pocket funds, or the executive may be able to use policy loans and/or withdrawals[1] from the policy to repay the employer. Policy dividends[2] and any partial surrenders of cash value are received as a return of cost basis first and gain last. This means that the executive will not pay taxes on these distributions until they exceed out-of-pocket premiums paid by him or her. In addition, borrowing from the policy will not result in taxable income as long as the loan is repaid with out-of-pocket payments while the policy is in force, or it is repaid from the policy death benefit.

Business owners are attracted by the simplicity (little or no documentation or IRS reporting) of the arrangement and by the fact that the business can use tax-deductible dollars[3] to fund it. An executive values the outright ownership of the life insurance policy that this arrangement will provide. The executive is also pleased that there will be a death benefit for his beneficiary in the event of his death.

[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty.

Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

Loan interest is charged when a policy loan is taken. If you take additional policy loans to pay loan interest, your policy's cash/account value will be reduced. At some point, no policy values may be available to pay additional loan interest, and out-of-pocket payments will be required to prevent the policy from lapsing. Failure to pay out-of-pocket amounts will result in the loss of life insurance coverage and a tax liability in the year of lapse.

[2] Dividends are not guaranteed.

[3] Employer receives a tax deduction provided the bonus qualifies as reasonable compensation to the executive.

What are the Options Available to an Executive at Retirement?

1. The executive can leave the policy intact.
2. The executive can take loans and/or distributions[1] from the policy to supplement his or her retirement income. Care should be taken to ensure that policy distributions are not so excessive that they cause the policy to lapse, which could result in taxes being owed. Be aware that surrenders and/or loans will reduce the policy's cash value and death benefit.
3. If the executive no longer needs the death benefit after retirement, he or she could work with a financial services professional to exchange the value into an annuity to obtain an income stream.

Consult your MassMutual financial services professional today, and they can provide you with additional information and can help you design a plan that meets your unique situation.

Additional Resources

Leveraged Bonus: Income Tax Deduction Plus Control Stratagy Snapshot

Executive Bonus Strategy Snapshot

Participating whole life insurance policies are issued by Massachusetts Mutual Life Insurance Company (MassMutual), Springfield, MA 01111-0001.