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A twist to Executive Bonus Plans

The Leveraged Executive (162) Bonus Plan

Business Planning Strategies

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Hill Gallagher
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JD, LL.M, CLU, ChFC

Richard C. Martin
JD, LL.M, CLU, ChFC, CFP

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JD, LL.M

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JD, CLU, ChFC

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JD, LL.M, CLU, ChFC

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The Leveraged Executive (162) Bonus Plan:

by Albert R. Kingan, JD, LL.M, CLU, ChFC

Overview

The Executive Bonus Plan (also called the § 162 Bonus) is an insurance-funded nonqualified fringe benefit that can be designed in a variety of ways to meet employer and employee objectives. The plan offers a current tax deduction to the employer for bonuses paid and results in current taxable income to the employee. Access to policy cash value can be limited and conditions can be added under a separate agreement that requires employee payback of bonuses. This payback requirement can cause substantial strife and lead to litigation between the parties. This article examines an alternative arrangement where the employer agrees to finance the employee's executive bonus tax liability in exchange for a note payable that could be forgiven if the employee meets certain employment requirements.

I/R Codes: 2400.02

Summary of the basics of Executive Bonus Plans

Simply stated, the Executive Bonus Plan is a life insurance fringe benefit plan where an employee owns a permanent life insurance policy on his or her life with the employer paying the premiums directly to the insuror or indirectly by means of a bonus paid to the employee. The premiums are deductible by the employer (assuming they represent reasonable compensation for services rendered) and are taxable to the employee as ordinary compensation income (i.e., wages). While there are many potential variations in the structure of an Executive Bonus Plan, these variations will generally follow one of three directions:

1 | The basic plan: An individual policy is issued with the insured as owner and paid for with employer bonuses. There is no endorsement to the policy restricting access to values and there is no agreement requiring the payback of any employer bonus;

2 | The basic plan coupled with a mechanism that restricts the employee's control of policy values until a future date or until the employee attains a specified age;

3 | The basic plan with restricted employee policy access plus an additional agreement that requires the employee to repay some or all of employer bonuses if specified conditions are not met.

The Executive Benefit Plan: The basic plan

The Executive Bonus Plan is appropriate whenever the employee has a need for permanent life insurance protection and the employer wants an immediate tax deduction. Typically the insurance is on the life of the participating employee; however it could be on another person in whom the employee has an insurable interest, i.e., the spouse or co-stockholder of the employee.[1] The employee usually owns the policy and designates a personal beneficiary, though the employee's irrevocable life insurance trust (ILIT), or another third party could own the policy. The employer pays the premium on the employee-owned policy and deducts it under IRC § 162. Section 162 allows deductions for reasonable compensation payments by an employer to an employee for services rendered. The employee in turn includes the same amount in his/her income tax return as compensation received and is taxed on it. If an ILIT or other third party is the owner of the policy, then the employer's premium payments will also have gift tax consequences.

The employer may or may not provide the employee with an additional bonus to cover the mandatory withholding on the value of the bonus. If the employer gives no additional bonus, the employee has an out-of-pocket outlay equal to the premium times his/her marginal tax bracket (plus the employee's FICA tax liability). The employer could choose to make an additional bonus payment in order to reduce or eliminate any out-of-pocket outlay for the employee. For example, assume an Executive Bonus Plan is funded by a policy owned by the insured with a premium of $1,000. The employee, in a 35% tax bracket, will have no additional out-of-pocket outlay if the employer bonuses to the employee an additional $538.46 (premium divided by 1, less the tax bracket).

Saving policy values for retirement only – The Restrictive Bonus

Some employers are concerned that policy values will not be available to provide the employee with the planned supplemental retirement benefits if the employee has unlimited access to policy cash values. The employee may be imprudent and spend rather than save policy values for retirement. For this reason, the employer may want to inhibit the employee's access to policy values without changing the features of the plan.

MassMutual permits a restrictive agreement to be placed on the policy at the time of issue, preventing the employee (policy owner) from accessing policy cash values until a specified future date without the consent of the employer.

There are two Restrictive Executive Bonus variations:

- **Vested Restrictive Bonus –** The employee's access to values is restricted until a future time, but no employer bonuses will ever have to be repaid because the benefit immediately vests.
- **Non-Vested Restrictive Bonus –** In addition to limiting the employee's access to cash value, the employer and employee sign a separate agreement requiring the employee to repay to the employer all (usually limited to the policy cash value at the time) or some of the employer bonuses received if stated conditions are not met.

Restrictive agreement with immediate vesting

This agreement restricts the ability of the policy owner to access the cash values of the policy without the consent of the employer. This limitation includes the right to borrow, surrender (partial or full), and take withdrawals or to change the dividend option (in a traditional policy) to cash or dividend accumulations without the written consent of the employer.

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[1] As part of a Cross Purchase Buy-Sell arrangement.

Despite this, the employer has no direct interest in the policy, and may not exercise any policy rights. The employer's only right is to consent to the exercise of ownership rights by the employee/policy owner prior to the stated termination date (if any) of the agreement. The restricted access under the agreement can be for a stated period of years, a fixed date, or the employee's attainment of a specific age.

The "payback" plan

Some employers want to add strings to the plan. The employer wants the benefit to be "non-vested" until a future date. If the employee does not remain employed until the magic date in the agreement, the employee is required to repay the employer. Until the employee meets the conditions of the agreement, the benefit is "non-vested." When the condition is met the benefit is "vested," i.e., no payback is required.

The payback requirement is formalized in a separate agreement between the employer and the employee. Unlike the restricted policy agreement, this agreement is not recorded at MassMutual. The employer has no security interest in the policy. Upon an employee's early termination of employment and the triggering of the provisions of the side agreement, the employer has no recourse to MassMutual for repayment of its bonus amounts.

What is an "appropriate" payback provision?

The purpose of the Executive Bonus Plan is to provide a special benefit to the employee as an incentive for the employee to continue to work for the employer. If, however, the repayment obligation would be burdensome to comply with, the arrangement is likely to only create animosity and perhaps litigation.

For example, assume that the employer required the employee to enter into an agreement requiring the employee to repay all prior premium bonuses if the employee terminates within five years. Annual policy premiums are $10,000. The employer provides the employee with an extra bonus to cover the employee's tax liability.

The employee terminates after the fourth, but before the fifth premium payment. The policy cash value is $25,000. The employer makes a demand for repayment of the $40,000 of premiums. The employee could transfer ownership of the policy to the employer, but he would still be $15,000 short. The employer might attempt to offset other amounts owed to the employee, such as a final salary payment, or accrued vacation pay. Despite the terms of the written agreement, any such action on the employer's part could very well trigger the employee hiring a lawyer.

So what would be a more appropriate repayment obligation? An agreement that called for the employee to repay the lesser of the premiums bonused or the current policy cash value would likely be viewed as a more appropriate repayment obligation.

How does the repayment to the employer actually occur? Unfortunately, the employer cannot have a direct security interest in the policy without jeopardizing its deductions for the value of the insurance premium bonuses. Section 264(a)(1) of the Internal Revenue Code provides that "no deduction shall be allowed for premiums on any life insurance policy if the taxpayer is directly or indirectly a beneficiary under the policy or contract." Giving the employer a security interest in the cash value of a policy in order to repay premiums if the employee terminates early appears to be in direct violation of § 264(a)(1).

What if the employee responds to the employer's repayment request with a threat; "I'm not giving you a dime, you'll just have to sue me." The employer will have to carefully consider whether it is worth the mental and financial aggravation to attempt to enforce the agreement. Plus there is always the possibility that the employee will allege discrimination or make some other claim against the employer. The employer may determine that the potential recovery is not worth the cost of litigation. In the end, the plan may not work. After which, the employer is unlikely to ever utilize, or even recommend, this planning technique.

And the employer's unhappiness with the overall result may jeopardize the relationship with the insurance and financial advisor. This is the real downside to an agreement that requires the employee to repay the bonuses.

A potentially effective alternative: The Leveraged Bonus Plan

With an Executive Bonus Plan the employer may provide the employee with an additional bonus sufficient to cover the employee's income tax liability on the value of the employer's life insurance premium. The Leveraged Bonus Plan is an alternative arrangement where the employer may make a loan to the employee of the funds necessary to pay the employee's tax liability. Coupled with the premium bonus and the tax liability loan, the employer may make a commitment to forgive the loan in the future if the employee meets certain criteria, such as remaining with the employer for a specified period of time, or until normal retirement. If the employee terminates before fulfilling the specified criteria, the loan to the employer must be repaid.[2]

The loan utilized to pay the employee's income tax liability can either be a non-interest-bearing note or it can accrue interest. If a non-interest-bearing note is used, the employee will have imputed taxable income each year in accordance with the below market rate loan rules of IRC § 7872. An alternative would be to use an interest-bearing note where the annual interest is accrued and added to the outstanding balance of the loan. The accruing of interest keeps the employee from having to recognize any immediate tax consequences from the loan arrangement.

If the employee terminates early under this arrangement, the employer has a claim not of the repayment of the premiums, but of the amount of the outstanding loan. By accruing interest on the outstanding loan, the value of the employer's interest continues to grow, giving the employer a right to a larger share of the life insurance policy's cash value.

Now, here's the real benefit to this alternative arrangement: While IRC § 264 prevents the employer from having a security interest in the life insurance policy for the repayment of premiums, there is no such restriction on the use of a life insurance policy as security for any other type of loan arrangement. Life insurance policies are regularly collaterally assigned to banks and lending institutions for business and larger personal loans. The life insurance policy can, therefore, be collaterally assigned from the employee to the employer as security for the repayment of the employer's tax loan.

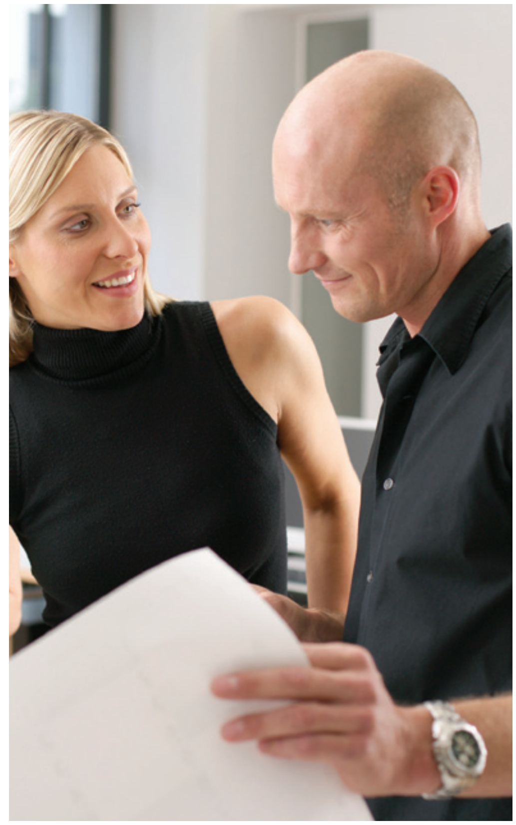
Upon an employee's "early" termination without meeting the criteria necessary for the loan to be forgiven, the employer can exercise its rights under the collateral assignment form to take a loan from the policy in order to recover the value of the note payable, including accrued interest. There is no need to request repayment from the employee. There is no need to threaten litigation to an uncooperative employee. And further, because the employer's security interest is not directly related to the payment of policy premiums, there is no questioning of the tax aspects of the transaction. [See Appendix for a discussion of the possible applicability of IRC § 83 to an Executive Bonus Plan with a separate side agreement detailing a repayment possibility.]

Finally, because the situation played out exactly as the parties knew that it would upon an early departure by the employee participant, the employer walks away pleased that its interests were adequately protected from the transaction. There will be no animosity against the selling insurance producer. In fact, the company owners are likely to be willing to use the same technique again in the future, and even to mention the arrangement in their social circles.

[2] The employer may also choose not to promise to forgive the tax loan in the future. Instead, the parties may look to the policy values including nonguaranteed policy dividends as the ultimate source of funds to repay the employer's tax loan.

Let's look at an example

Kate, age 45 (select preferred, non-tobacco), is a valuable employee of JLH Innovators, an architectural firm. Her employer, Jonathan, has decided to provide Kate with an Executive Bonus Plan with an annual life insurance premium of $20,000. Jonathan has agreed to loan Kate the $6,800 per year that she will need to cover her assumed combined 34% tax liability on the bonus value. The loan will accrue interest at an interest rate sufficient to prevent Kate from having any current income tax consequences resulting from the loan. We'll assume 5%. Jonathan has told Kate that if she continues her employment until age 65 that the entire loan and accrued interest will be forgiven.



The following chart illustrates the bonus plan and loan arrangement utilizing a hypothetical life insurance policy. As you can see, if Kate terminates her employment during the next two years, the policy has insufficient funds to fully repay the loan to JLH Innovators. However, beginning in year three, the loan from Kate's employer is fully collateralized.

Concept at a glance

Year	Cumulative Premiums	Cumulative Tax Loans	Cumulative Tax Loans w/ Accrued Int.	Executive CSV Net of Loan	Executive Death Benefit Net of Loan
1	20,000	6,800	7,140	-6,613	918,833
2	40,000	13,600	14,637	-4,366	913,289
3	60,000	20,400	22,509	7,733	907,391
4	80,000	27,200	30,774	20,094	901,120
5	100,000	34,000	39,453	32,701	894,489
10	200,000	68,000	89,806	108,291	879,657
15	300,000	102,000	154,071	204,150	896,401
20	400,000	136,000	236,091	347,446	963,640

This is a hypothetical example only, not intended to represent the performance of any specific product.

Other issues

There will be no need for a restrictive agreement on the employee's policy, since the collateral assignment to the employer restricts the employee's access to policy cash value without the consent of the collateral assignee.

The employer's promise to forgive the loan in the future if the employee satisfies certain employment conditions (i.e., the employee continues working for the requisite period of time) is essentially a deferred compensation or SERP (supplemental employee retirement plan) benefit. This promise needs to be in a written agreement complying with the new IRC § 409A rules.

One of the design options in setting up the plan is the determination of when the employee should be taxed on the forgiven loan and interest once the employment requirement is met. For example, let's assume that the employee is 50 years old. The employer provides the bonus and tax loan to the employee, agreeing to forgive the loan and interest if the employee remains with the company for the next ten years. The design issue is whether the plan should call for the forgiveness as soon as the employee hits the ten-year mark, or when the employee ultimately terminates after that date.

If the plan is to forgive the loan at the ten-year anniversary, the employee will be taxed on the loan forgiveness at that time. A second part of the plan design is the employer's consideration regarding whether and to what extent it will cover the employee's tax liability on the forgiven loan value. To the extent that the employer does not provide a "gross-up" payment sufficient to cover the employee's entire withholding tax liability, the life insurance policy cash values can be used as the necessary source of funds.

ERISA implications

ERISA applies to all employee benefit plans but only applies if a "plan" is found to exist. A benefit negotiated by an employer and a single employee may not be a plan for purposes of ERISA. If an employer, however, offers a plan to a group of employees and makes all decisions with respect to plan design, then sufficient evidence may be present for a finding that a plan exists.

If the Executive Bonus Plan is a "plan" it is a Welfare Plan. For a Welfare Plan, the ERISA requirements will differ depending on the number and type of employees who are participants. When a plan covers only select management or highly compensated employees (the top hat group), ERISA is satisfied if the plan is in writing and contains certain required provisions such as claims procedure, named fiduciary, etc. No other filings are necessary.

If the plan includes employees other than the top hat group and the total number of covered employees is less than 100, the employer must also provide each employee with a summary plan description. If the plan covers 100 or more participants, the employer must also file an annual report and summary annual report.

Some suggest that the Executive Bonus Plan be incorporated into an employment contract for the employee. This strategy would strengthen the argument that the plan is not a "plan" for ERISA purposes because it is an individually negotiated benefit. But, employers should be cautious, especially for employees who would not otherwise have a written employment agreement. Care should be taken that the agreement does not give the employee unintended employment rights.

As indicated, an employer's promise to forgive the employee's outstanding tax loan is a Nonqualified Deferred Compensation Plan, which is also a plan subject to ERISA. Such plans that are "unfunded" and are primarily for the purpose of providing deferred compensation for "a select group of management or other highly compensated employees" are exempt from most of Title I of ERISA, including its participation, funding, and vesting requirements. Most Nonqualified Deferred Compensation Plans are designed to meet these so-called "Top Hat Plan" criteria. In such cases, only the requirements regarding reporting, disclosure, administration and enforcement generally need to be met.

Conclusion

The Executive Bonus Plan is an excellent planning option for the employer to consider when a simple, currently deductible plan is needed. The plan can limit access of the employee to values while employed so that they will be available for retirement and/or death benefit needs. In the past employers who wanted a "golden handcuffs" benefit would require employees to sign a separate side agreement calling for the repayment of the employer's premium bonuses if the employee did not stay with the employer for a specified period of time. The side agreements, however, create a possibility of conflict and even litigation between the employer and the employee, and called into question the employer's deduction for the premium payments.

The Leveraged Bonus Plan is an attractive, efficient, and safer alternative to a separate repayment agreement. Coupled with a formal employer promise to forgive the loan when the employee meets the employer's longevity requirements, the Leveraged Bonus Plan provides the golden handcuffs that protects both parties and promotes an attractive work environment. The Leveraged Plan should reduce the threat of litigation and increase the satisfaction level of all parties to the transaction.

Appendix

Tax consequences of the Executive Bonus Plan with/without payback

The Executive Bonus Plan has been described as an uncomplicated plan with straightforward income tax consequences. The employer pays a bonus and deducts it under IRC § 162, while the employee includes the same bonus amount in income under IRC § 61. Three additional issues, however, need to be explored to provide a more complete treatment of the potential income tax benefit.

1 | Does IRC § 83 apply, rather than § 162 and § 61?

2 | Does a payback feature mean the employer gets no deduction until "vesting"?

3 | Does the employee receive a tax deduction if a payback is made?

Does IRC § 83 apply?

IRC § 83 deals with the taxation of property (which according to Treas. Reg.§ 1.83-3(e) does not include cash) transferred by an employer in connection with the performance of services. If an employee is paid for services rendered in property rather than cash, the employee, under IRC § 83, must include the fair market value of the property in income as soon as it is no longer subject to a "substantial risk of forfeiture."

IRC § 83(c) provides that a substantial risk of forfeiture exists if the employee's full enjoyment of the property is conditioned upon the future performance of substantial services. Thus, if the receipt of the benefit by the employee is conditioned on the employee's continued employment, then a risk of forfeiture exists. If receipt of the benefit is not conditioned upon continued employment, then the employee is vested and is guaranteed to receive the benefits, either immediately or sometime in the future.

Is the Executive Bonus Plan subject to the provisions of IRC § 83? If we find that the bonus payments constitute the transfer of "property" rather than the payment of compensation in "cash or its equivalent," the answer is yes. However, the § 83 regulations make it clear that the term "property" does not include money. In an Executive Bonus Plan, the employer owns no interest in the policy and has no right to reclaim the policy. For this reason, it is reasonable to conclude that the plan does not involve the transfer of property and is not, therefore, subject to IRC § 83.

If a plan were subject to IRC § 83, the tax consequences may be different. If the employee is immediately and fully vested, the employee is taxed on the bonuses when paid pursuant to IRC § 83(a) and the employer would get a deduction at the same time under IRC § 83(h).

If the employee is not immediately vested (and § 83 applies), the recognition of income by the employee would be postponed until vesting, as would the employer's deduction. For example, if the employee fully vests after five years under a "cliff vesting" arrangement, the employee has no income to recognize until the fifth year. At that time, the employee would include the cash value of the underlying policy in income and the employer would get a corresponding deduction. Thereafter, each bonus paid by the employer is immediately taxable to the employee and deductible by the employer.

If the employee could be required to return the policy to the employer because a plan condition has not been met, then § 83 is more likely to apply. For this reason, the plan should not require the transfer of the policy to the employer. Generally, such agreements create an unsecured personal obligation of the employee to repay the bonuses.

Section 83(b) election

When an employer compensates an employee through the transfer of property subject to restrictions, the employee may elect under IRC § 83(b) to include the value of the property in income currently even though it would not otherwise be taxable until the restrictions lapsed. The employee exercises this right by timely filing a § 83(b) election with the IRS. The election must be made within 30 days after the property is transferred using a procedure set out under Reg. § 1.83-2(e).

If the Executive Bonus Plan has a vesting schedule and the IRC § 83 is thought to apply, a § 83(b) election by the employee results in immediate taxation to the employee and a deduction for the employer.

Tax consequences of repayment

If the Executive Bonus Plan utilized by the employer contains a vesting schedule and the employee fails to satisfy the conditions for vesting, the employee will be required to repay to the employer some or all of the bonus amounts previously received.

What is not clear is whether or not the employee is entitled to any type of income tax deduction for these repayments. IRC § 1341 (the so-called "claim of right rule") may be helpful in giving the employee income tax relief. Section 1341 has a three-part requirement:

1 | An item is included in income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such item;

2 | It is established in a subsequent year that the taxpayer did not have an unrestricted right; and

3 | The amount of the deduction exceeds $3,000.

Under a payback bonus arrangement the employee has an unrestricted right to the death benefit under the plan and needs to repay the employer bonuses only on the contingency that employment ends prior to vesting. At the time each bonus is paid the employee has a "semblance" of an unrestricted right (the term used in Revenue Ruling 68-153, 1968-1 C.B. 371) to the bonus, which may never have to be repaid. When the employee utilizing this section claims a tax deduction for prior bonuses, the employer also would need to reverse the transaction and include these prior bonuses in income.

The employee, however, would not be permitted to claim a deduction for the repayment if he/she had made an IRC § 83(b) election to be currently taxed despite a risk of forfeiture. The inability to claim a deduction after a bonus repayment makes it unlikely that an employee would voluntarily make a § 83(b) election when there is a payback requirement.

[Note again that the issues described in the appendix can be avoided with the use of the Leveraged Executive Bonus Plan and side deferred compensation arrangement described in the article.]

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