IFG MEMO

LOOKING FOR AN EASY BONUS PLAN?

This one's easy to implement, and cost-effective, too!

Try a Section 162 Plan: Executive Bonus

James Lorenzen, CFP®

Executive Bonus plans are a little different from Non-Qualified Deferred Compensation Plans (NQDC), which we talked about in another short paper. But, these types of plans are very popular!

Basically, it involves the purchase of a life insurance policy on the life of one or more employees, chosen by the employer. The employer pays the premium on the policy but charges the employee with a bonus with an amount equal to the payment. Under other arrangements, the employee can pay the premium and the employer adds the amount of the premium to the employees paycheck.

The employee (or a third party, such as an irrevocable trust designated by the employee) purchases and owns the policy and even names the beneficiary. The employee-policy owner has all the rights in the policy. The corporation never has any right to any part of the policy cash values, dividends, or death benefit. In fact, the corporation never has any incident of ownership in the policy.

Why does a corporation do this?

- Unlike the NQDC, the corporation, under IRS Section 162, can take an immediate tax deduction for the amount of the bonus.
- It provides valuable life insurance for key employees at little or no-out-of-pocket costs. The corporation has a great deal of freedom in deciding just who will be covered and has considerable flexibility, depending on the product type, regarding how much premium to pay. If cost is an issue, a permanent universal life product can provide essentially a term insurance equivalent.
- It's completely confidential. No one other than covered employees need know about the plan
- It can be terminated by the employer at any time for any reason without justification to the IRS or the Department of Labor. There's no termination penalty, as is the case with a qualified plan.
- It may be the most inexpensive and easy plan to implement and maintain.
- It's appreciated because these plans provide real benefits for the chosen employees – and the benefits cannot be forfeited. Unlike a NQDC plan, assets in a Section 162 plan belong to the employee and cannot be reached by the employer's creditors.
- The policy is portable. Termination of employment has no impact on policy values.
- Present or future management may discontinue premium payments, but the employee will not lose anything if the business is subsequently sold or there is a corporate takeover.
- Premiums payments may self-complete if the selected employee becomes sick or suffers an accident, if there is a disability waiver of premium rider. Cash values will continue to grow.
- Cash values, which accumulate income tax deferred, can be turned into tax-free supplemental retirement income, cash for an education, or any other need, in the form of policy loans.\

Disadvantages:

- Once the premium is paid, the employer generally has no control over either the employee or the policy. This can be somewhat controlled using a "Controlled Executive Bonus arrangement", however, the employer bonus is generally enough of an incentive for the employee.

- Cash values are controlled by the employee; but then, it is a bonus plan and the employer did receive a tax-deduction for it.
- None of the cost of the plan will ever be recovered by the employer, compared to a split-dollar plan, which allows recovery of employer costs. However, bonus payments are seldom recoverable anyway; and, as stated earlier, this is one of the easiest and least expensive plans to set-up and maintain.

Tax implications:

- Bonus payments made, whether to the employee to pay the insurer or directly to the insurance company, are deductible by the employer.
- The bonus (premium) is reportable as income by the employee
- It's likely that the payments will be considered a non-cash fringe benefit for withholding purposes, meaning that premium amounts should be added to regular cash wages and subject to appropriate withholding.
- Since the employee has already paid tax on the full cost of the policy, the employee's cost basis is equal to the sum of the all premiums paid by the employer. This basis can be used to offset income tax as amounts are withdrawn when the policy is surrendered.

To learn more, talk with your advisor, or seek out an independent insurance professional. Look for credentials such as CFP, ChFC, or CLU. An independent will not only know the ins-and-outs of the ratings agencies (some highly-rated companies have failed during past melt-downs, remember?), as well as which companies stand-out in this part of the market. The right advisor should be able to bring the right experts to the table for you.

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805.265.5416 · info@indfin.com

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