Business by Design

IRC Section §162 Restrictive Executive Bonus Arrangements (REBAs)

The Independent Financial Group

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Your Key Employee is Thinking of Leaving

A Competitor is offering a qualified plan and your business isn't ready to cover all employees.

After founding and growing several businesses of my own some years back, I was able to enjoy about six years in management consulting, specializing in organization development and competitive strategy. During those experiences, I learned what every business owner I met intuitively knew: Buildings and equipment don't make money; people do.

Productivity comes from people. While economies and labor demands will always fluctuate in the marketplace, the demand for quality key people is virtually constant – and they key, of course, is keeping the good ones.

While the Employee Retirement Income Security Act (ERISA) legislation provides a framework for employers to sponsor qualified plans, the funding limitations and participation requirements are often (translate: virtually always) too burdensome for both employers and the key executives.

Executive Bonus Plans

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The typical executive bonus arrangement (also known as Section 162 bonus plans) provides a simple and easy way to provide an incentive to a key executive.

Advantages to the employer:

- Selectivity – an employer can select one or a select group of employees, excluding all others.
- Current tax deduction – the bonus is considered compensation to the executive
- Administrative simplicity – no government reporting or disclosure requirements

Advantages to the employee:

- Post-retirement benefits
- Limited cost – taxes on the bonus
- Use of business dollars – employer is funding the benefit
- Portability and flexibility – biggest disadvantage for the employer: the plan can move with the executive, making loss of control an issue for the employer.

It's because of the last point many business owners elect the REBA – a Restricted Executive Bonus Arrangement. The funding mechanism is life insurance, for reasons you'll soon understand.

The Restricted Executive Bonus Arrangement (REBA)

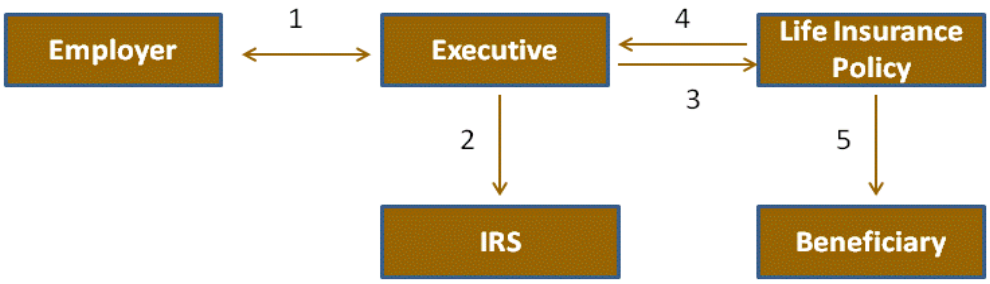
Unfortunately, the implementation of an executive bonus arrangement doesn't ensure the employer will enjoy the intended benefits. The executive may decide to retire early, leave to take a job with another company, resign to start-up his/her own competing company, or even engage in activities detrimental to the employer like fraud or embezzlement. The employer can place restrictions on the use of the life insurance policy to reduce the risk of these events and to address the last bullet point on the previous page.

The REBA, sometimes called GEBA for Golden Executive Bonus Arrangement, can help provide the 'golden handcuffs' needed to keep a key executive (or group of key employees) through a selective arrangement while getting a tax deduction at the same time.

The REBA is a simple and straightforward method of rewarding an executive over and above salary and other benefits. Under a REBA, the executive applies for, owns, and names the beneficiaries of a life insurance policy. The employer pays the premium directly to the insurance company or pays the bonus to the executive who then pays the premium. The payment is considered compensation to the executive. [I.R.C. §61(a)] The bonuses, if considered reasonable compensation, are tax deductible to the employer when paid. [I.R.C. S §162(A)(1)] Also, the bonuses are treated as wages and therefore subject to FICA and FUTA withholding.

Easy to set-up: A simple corporate resolution, signed by both the executive and the employer, is usually all that's required to set-up the arrangement. The restrictions can be included in the resolution, a separate restricted endorsement agreement, or in a comprehensive employment agreement.

How a REBA works:



1. Employer and executive enter into agreement that employer will pay employee a bonus which will be used to pay the annual premiums on a life insurance policy. The parties may also file a restrictive endorsement or "modification of ownership rights" form with the insurer to restrict the executive's ability to exercise ownership rights during the term of the agreement. Bonus payments are tax deductible by the employer (assuming total compensation is reasonable).
2. Executive pays tax on bonus as ordinary income.
3. Executive applies for, purchases and owns a permanent life insurance policy which builds cash values.
4. Executive may receive income through withdrawals and loans from the policy's cash value, subject to limitations included in the agreement.*
5. At executive's death, income tax-free death benefit proceeds are paid to the executive's named beneficiary.**

*Policy loans and partial withdrawals may vary by state, reduce available surrender value and death benefit, or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to cost basis (usually premiums paid), followed by policy loans (but only if the policy qualifies as life insurance, is not a modified endowment contract, and is not lapsed or surrendered.

**Death proceeds from a life insurance policy are generally income tax-free and, if properly structured, may be free from estate tax value and death benefit. This assumes the policy qualifies as life insurance and does not lapse.

Types of REBA restrictions

The employer and executive an negotiate any number of restrictions in the endorsement. Once executed, the endorsement should be filed with the insurance company issuing the policy. The endorsement should be reviewed by legal counsel and your advisor should be able to coordinate the entire process involving the insurance company. Note: A supplemental employment agreement may also be used to "handcuff" the executive.

Among the rights which may be restricted are rights to surrender the contract, make a policy loan, or pledge the contract as collateral for a loan. The endorsement can require that the employer must consent in writing to the exercise of certain ownership rights before the executive an exercise them.

The restrictions do not limit the executive's right to unilaterally designate and change policy beneficiaries, but written consent of the employer to exercise other ownership rights could be required.

The endorsement can also be designed to expire at some point in the future such as, a specific age of the executive, a specified date, upon the executive's retirement, or a change in business ownership.

Potential advantages of a REBA

- A reward to selected key executives
- Amounts of insurance coverage on various executives can vary with each executive
- Size of bonus can vary from year to year to reflect achievement of business objectives
- Can be terminated without IRS notification, approval, or restrictions
- Contributions are fully deductible if the total compensation is reasonable
- Simple to implement and administer
- Restrictions can be placed on certain executive rights
- May not be required to comply with Section 409A and its regulations – legal counsel should be consulted.

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Executive's advantages

- Can be customized to executive's individual needs
- Beneficiary death benefit is generally received income-tax-free
- Policy cash values can grow tax-deferred and can be available to the executive for emergencies, retirement, or other needs with the employer's consent.
- May voluntarily contribute personal funds to the policy (not subject to REBA restrictions) to potentially increase cash value and supplemental retirement income.
- Once restrictions have lapsed, retirement benefits can be accessed income-tax-free through proper structuring of loans and withdrawals as long as the policy remains in force.[i]
- Executive owns the policy at all times and policy's cash values are not exposed to the claims of employer's creditors.

Does a REBA make sense for you?

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Typically, all that's needed is a simple corporate resolution establishing the arrangement.

Examples of businesses that can benefit include, but are not limited to:

1. A closely-held business with non-owner key executives

2. Small businesses where qualified plans may be too expensive

3. Where the employer would like to provide additional insurance benefits to a select group of executives "carved out" of a group term insurance plan

4. Companies in a higher tax bracket than the executive where the combined tax paid can be reduced.

> Example: The business owner is in the 34% tax bracket and the executive is in the 28% tax bracket. When the owner bonuses $10,000 to the executive, the owner's cost is $6,600 after the tax deduction. The executive pays $2,800 in taxes on the bonus, leaving $7,200 that can be used to help pay the insurance premiums. The net tax savings using an executive bonus arrangement in $600 [(34%-28%) x $10,000].
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> Note: Many REBA/GEBA arrangements are structured to "gross-up" the bonus to cover the employee's taxes on the bonus, as well, making it even more attractive to the key employee.

5. Companies wishing to find a replacement for qualified plan benefits

Almost any type of insurance can be purchased as part of a Section 162 bonus arrangement. By offering traditional life insurance, employers can offer a meaningful portable benefit that may be structured to provide key executives with family protection, supplemental retirement income and/or estate liquidity.

The Takeaway

The REBA can provide significant death and retirement benefits while allowing the employer to retain a degree of control over those benefits. In addition to providing a tax-efficient funding vehicle, a REBA can be structured to accumulate retirement funds and post-retirement life insurance coverage. They can be a simple and effective solution for employers who don't want to deal with the restrictions of nonqualified plans under Code section 409A; yet, like nonqualified plans, REBA plans can "tie" key executives to the company. The longer the executive stays, the larger the potential benefit.

Important information and disclosures follow.

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[i] Income tax-free distributions are achieved by withdrawing cash value up to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may reduce the policy's cash value and death benefit. This assumes the policy qualifies as life insurance and does not lapse.