Executive Bonus Plans and Restricted Endorsement Bonus Arrangements

ADVISOR COMPANION

BUSINESS PLANNING

A simple and flexible plan to motivate and reward key employees

In today's competitive business environment, business owners face several challenges in attracting and rewarding key employees, particularly for small, closely held businesses or pass-through entities. Employers often seek a solution that is simple to implement and administer, tax-deductible, and includes a "golden-handcuff" element. Employees want tax-advantaged ways to save for retirement and protect their families. What's more, employers and employees alike are looking beyond pure financial compensation towards more holistic planning, incorporating health and wellness programs as a component of a total rewards package.

An Executive Bonus Plan (aka "162 Bonus Plan") or a Restricted Endorsement Bonus Arrangement (REBA) with the John Hancock Vitality Program may be an excellent solution to achieve these goals. Under both of these plans, an employer selects a key employee to purchase a permanent life insurance policy on his/her life. The insurance premiums are then paid for by the employer in the form of a bonus to the employee.

The Value of Permanent Life Insurance

A John Hancock permanent life insurance policy can offer many benefits for a key employee and his/her family in all stages of life:

- **PROTECTION:** income tax-free death benefit provides valuable protection to the employee's family[1]
- **TAX-DEFERRED GROWTH:** cash value grows tax-deferred
- **TAX-FREE ACCESS:** to potential cash value to supplement future retirement income[2]
- **NOT SUBJECT TO QUALIFIED PLAN LIMITATIONS:** no funding limits, RMDs, penalties before age 59½
- **OPTIONAL RIDERS ENHANCE POLICY'S VALUE:** adding John Hancock's Long-Term Care, Disability Payment of a Specified Premium, and/or Critical Illness Benefit riders can protect the employee from health and long-term care events and increase the total value of the plan
- **REWARDS FOR HEALTHY LIVING:** John Hancock's innovative Vitality PLUS offers employees rewards and savings for living healthy

LIFE-7714 6/19

Putting a Plan in Action

To create a plan that will work for all parties, the following items must be addressed:

1. Identify the Key Employees

- The employer can select individual employees, or a class of employees, who would be difficult to replace to participate in the plan. Consider:
  - *Who are the key employees in the business?*
  - *Does the employer want to retain and reward these key employees?*
  - *Is the employer looking to recruit new employees to key positions?*
  - *Is the employer concerned with employee health and wellbeing? Are they interested in implementing a corporate wellness program, but think it will be too costly?*

If desired, the employer can craft a unique plan for each individual employee.

PLANNING NOTE

Include the Business Owner in the Plan.

It may make sense to include the business owner in similar type of arrangement. The life insurance will be paid for using business funds, and because the policy will be owned outside of the business, it will not be subject to creditors of the business. Depending on various factors, the funds received from the business may be considered wage income or a dividend/distribution to the owner. For pass-through entities (e.g., S Corp, LLC, partnership), taking a distribution to pay the premiums is often tax neutral.

2. Establish the Funding Pattern and Employee Tax Cost

- The employer has the discretion to apply a unique funding stream for individual employees or classes of employees. The only requirement is that the bonus amount selected is "reasonable" compensation for each employee.
- The employer has the choice of funding the plan using a "single bonus," which means the employee will pay the tax due out-of-pocket. Another option is to use a "double bonus" approach, which means the employer will increase the bonus amount to include the tax payable by the employee. Under a "double bonus" plan, the employee will have no out-of-pocket expenses.

3. Explore Vesting Options

- In an Executive Bonus plan, the employee is 100% vested immediately. The employee is free to use the policy as he/she desires at his/her sole discretion. This is very good for the employee, and may be attractive to the employer if the only purpose of the plan is to reward the employee. However, if the employer wants to provide increased incentive to the employee to remain working in the business, then the employer may prefer a REBA plan.
- In a REBA plan, the employer may create a vesting schedule to provide an additional "golden handcuff" on the employee. If the employee decides to leave the company prior to becoming 100% vested, he/she may be required to repay the unvested portion back to the company. The vesting schedule can be as creative and/or restrictive as the employer wishes.

In a REBA plan, while the vesting schedule is ultimately to protect the employer, it should be perceived by the key employee as reasonable. If not, the key employee may feel that the plan loses its value.

Two of the most common vesting schedules are:

CLIFF VESTING

The bonuses for the premium are 0% vested until a specific year, at which time they become 100% vested. If the employee leaves before then, the bonuses must be repaid to the employer. A plan that calls for the employee to have no vesting until year 10 would be an example of cliff vesting.

VESTING PER YEAR

A set percentage of the total bonuses paid vests each year. If the employee leaves the company, the unvested portion of the bonus would need to be repaid.

An example of this approach is provided in the hypothetical example on page 5.

4. Determine Restricted Endorsement Features (if any)

- For a REBA, a "Restricted Endorsement" will be recorded with John Hancock that may limit the employee's rights to certain policy features, including:
  - Surrendering the policy for its cash value
  - Making cash withdrawals and/or borrowing from the policy
  - Assigning or pledging the policy as collateral
  - Changing the ownership of the policy
- The employee generally will remain restricted from accessing the policy cash value until the earlier of: (i) a specified restriction period (e.g., 10 years), or, if a vesting schedule is used, at such time the employee is 100% vested in all premium bonuses. If employee leaves prior to becoming fully vested, he/she may be required to repay the unvested portion of the premiums in order to have the Restricted Endorsement removed.
- Access to restricted rights may be waived with the employer's consent.

5. Execute a Contractual Agreement

- The employer and employee will both sign a plan agreement, drafted by an attorney, that details the obligations of all parties to the plan.

Key Benefits

An Executive Bonus Plan or a REBA plan may provide advantages for both the employer and the key employees, as listed below:

BENEFIT/FEATURE	BONUS	REBA
Portable death benefit protection for the key employee	✓	✓
The key employee can name the policy beneficiary	✓	✓
Death benefit is income tax free to beneficiary	✓	✓
Key employee owes nothing to the employer if he/she terminates employment	✓	Depends on vesting schedule
Not subject to qualified plan limits, penalty provisions, or RMDs	✓	✓
Tax-deferred cash value accumulation	✓	✓
Creditor protection of policy death benefit and cash value	Depends on state law	
Access to policy cash value at any time	✓	Depends on terms of "Restricted Endorsement"
Potential source of supplemental retirement income	✓	Depends on terms of "Restricted Endorsement"
Access to death benefit for long-term care costs when an LTC rider is added to the policy	✓	✓
Premium paid by John Hancock if you are disabled when a total disability rider is added to the policy	✓	✓
Rewards for living healthy with the John Hancock Vitality Program.[3] There are two great versions of the program, Vitality GO*, included on all our flagship products — at no additional cost. And Vitality PLUS, an enhanced version of the program offering even greater rewards.	✓	✓

*Vitality GO is not available with policies issued in New York.

Hypothetical Example

Sue is the owner of a successful business. Marie, age 42, has worked for the business for the past 10 years and Sue considers Marie to be one of her most valuable full-time employees. To reward Marie for her hard work and to encourage Marie to stay with the company on a long-term basis, Sue's advisor suggested a REBA as a cost-effective way to provide Marie with an executive benefit.

Accordingly, Sue and Marie enter into a REBA Plan, whereby Sue agrees to pay Marie a bonus for the annual premium on a life insurance policy that Marie will own. Because Sue does not want Marie to have any out-of-pocket tax costs, she also agrees to bonus out the tax that Marie would have been required to pay on the premium bonus (i.e., a "double bonus"). The business tax bracket is 35% and Marie's personal tax bracket is 30%.

1

Marie purchases a John Hancock Accumulation IUL policy on her life*

- **Death benefit** = $665,983
- **Premium** = $10,000/year for 23 years
- **LTC rider benefit** = $26,639 up to 25 months**
- **Vitality PLUS:** (Gold status is illustrated)

2

Marie records a Restricted Endorsement with John Hancock limiting her policy rights for 10 years, which is the length of time of the vesting schedule

3

- **The business will pay the annual premium of $10,000**, but such premiums are subject to a vesting schedule whereby Marie vests 10% each year so that she is 100% vested in all premiums by year 10
- **The business also agrees to pay the tax that Marie would have to pay on the bonus** (assuming Marie's 30% tax bracket) over the 10 years the agreement is in place

4

During vesting period:

- **If Marie terminates employment prior to vesting**, she agrees to repay the business a portion of the unvested bonuses already paid, which could range from $9,000 to $25,000 depending on the year. See the following page for an example of this type of vesting schedule.

5

Once vesting period ends:

- **Marie is fully vested in the policy** and the Restricted Endorsement is removed
- **Marie may make loans and withdrawals from the policy**. Under current assumptions, it is projected that if Marie continues to work to age 65, she would be able to withdraw/borrow roughly $60,000 annually from the cash value of the policy from age 70 through age 79, if she desires
- **The business will continue to pay the insurance premiums** until year 23, when the policy is projected to be paid-up.

* 6% assumed rate of return
** Assumes 4% benefit
This is a supplemental illustration. Not all benefits and values are guaranteed. The assumptions on which the non-guaranteed elements are based are subject to change by the insurer. Actual results may be more or less favorable.

HYPOTHETICAL EXAMPLE (CONT'D)

YEAR	ANNUAL PREMIUM BONUS	CUMULATIVE PREMIUM BONUS	VESTING SCHEDULE	ANNUAL VESTED AMOUNT	CUMULATIVE UNVESTED AMOUNT
1	$10,000	$10,000	10%	$1,000	$9,000
2	$10,000	$20,000	20%	$3,000	$16,000
3	$10,000	$30,000	30%	$5,000	$21,000
4	$10,000	$40,000	40%	$7,000	$24,000
5	$10,000	$50,000	50%	$9,000	$25,000
6	$10,000	$60,000	60%	$11,000	$24,000
7	$10,000	$70,000	70%	$13,000	$21,000
8	$10,000	$80,000	80%	$15,000	$16,000
9	$10,000	$90,000	90%	$17,000	$9,000
10	$10,000	$100,000	100%	$19,000	$0
TOTAL				**$100,000**	**$0**

Important Considerations

Longer Time Horizon — Both an Executive Bonus Plan and a REBA Plan should be considered long-term planning approaches. The minimum time horizon should be ten years, but shorter durations can be considered if growing cash value is of secondary importance.

Income Taxation — Premium payments made by the employer are generally believed to be compensation to the employee under IRC Section 61.[4] Therefore, subject to "reasonable compensation" limitations outlined in §162, an amount equal to the total bonus paid will be income taxable to the employee, and the employer will receive a corresponding current deduction.[5]

Employers often use a "double bonus" approach to add value to the plan. This may be particularly true for a REBA plan as the employer will use the double-bonus approach as inducement to the key employee to accept a restricted endorsement, such as a vesting schedule.

- ***Executive Bonus Plans*** — For traditional Executive Bonus plans, the taxation is straightforward: the employer can deduct from its income the total bonus paid and the key employee will be required to pay income tax on the total bonus. If the total bonus equals the premium paid (aka "single bonus"), the key employee must pay the tax due out-of-pocket. If the total bonus equals the premium plus an amount to cover taxes (aka "double bonus"), the key employee may have zero out-of-pocket cost.
- ***REBAs*** — For a REBA plan, the taxation is more nuanced. The presence of a vesting schedule may create a "risk of forfeiture" to the key employee, which some practitioners maintain entitles the key employee to exclude the unvested bonus payment from taxable income until it vests and that the employer's deduction is also delayed until that time. Other tax practitioners, however, may prefer to treat each premium bonus, regardless of a vesting schedule, as fully taxable to the key employee and, therefore, deductible by the employer.

Clients must seek advice on from their legal/tax counsel to determine the appropriate timing of taxation and deductions.

IRC 409A — A REBA plan must comply with the provisions of Section 409A of the Internal Revenue Code and the applicable regulations. However, because REBA is a non-elective deferral, and the employee pays taxes on the bonus as it vests, complying with the provisions of Section 409A should not be difficult.

ERISA — The Employee Retirement Income Security Act of 1974 (ERISA) controls all employee benefit plans and divides them generally into two types of plans: welfare benefit plans and pension plans. A welfare benefit plan generally describes a plan maintained by an employer that provides its participants, or their beneficiaries, through the purchase of insurance, benefits in the event of sickness, accident, disability death or unemployment. Alternatively, a pension plan describes a plan established by an employer to provide retirement income to employees or results in a deferral of income by employees for periods extending to the termination of employment or beyond.

To be covered by ERISA, there must be a "plan, fund or program" that provides an employee benefit. There is no clear consensus as to the applicability of ERISA to 162 Bonus or REBA plans so clients must seek counsel to determine whether the facts and circumstances of their arrangement constitutes an employee benefit plan that falls under the purview of ERISA. **If ERISA applies, advisors should note that they may be considered a fiduciary and should take appropriate steps to comply with ERISA requirements, including conflict of interest rules**.

Conclusion

An Executive Bonus Plan or a REBA Plan can be a simple, tax-deductible option for an employer to use to recruit, reward, and retain the employees who matter the most to the business. Under these plans, an employer can provide an incentive for the key employees to remain working for the business,while the employees enjoy low-cost life insurance death benefit protection, access to potential future supplemental income, and — with John Hancock Vitality life insurance — a wellness program that can help them live longer, healthier lives.

Contact the John Hancock Advanced Markets team for a customized client proposal using the JH Solutions software. You can reach the Advanced Markets team at 888-266-7498, option 3.

1. Life insurance death benefit proceeds are generally excluded from the beneficiary's gross income for income tax purposes. There are a few exceptions, such as when a life insurance policy has been transferred for valuable consideration.
2. Loans and withdrawals will reduce the death benefit and cash surrender value, and may cause the policy to lapse. Withdrawals in excess of the premiums paid will be taxed as ordinary income. A policy with a loan that lapses or is surrendered may trigger the recognition of taxable income. Policies classified as modified endowment contracts (MEC) may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% of the taxable income may apply to a MEC if the loan or withdrawal is taken prior to age 59½.
3. Employers should seek legal counsel regarding the potential application of the Americans with Disabilities Act (ADA) and/or the Genetic Information Nondiscrimination Act (GINA). See our BYA on JH Vitality in the Employer Marketplace for more information.
4. See Treas. Reg §1.6.1.2(d)(2)(ii)(a) ("Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee.").
5. IRC §162 provides an income tax deduction for "ordinary and necessary" business expenses, including reasonable compensation (up to $1,000,000 per employee). However, IRC §264 provides that the employer is not entitled to a deduction when the employer is directly or indirectly a beneficiary of the insurance policy.