Attract, Retain, and Reward with Executive Bonus Plans

Today, many business owners see the **executive bonus plan** as one of the most cost-effective fringe benefit plans available for solving personal needs in the new millennium. Let's review the details.

The Double Bonus Plan

Stripped of all "bells and whistles," an executive bonus plan can be provided as an executive-owned **life insurance** policy, with premiums paid by the business. Premiums are generally tax deductible to the business (provided the premiums are reasonable compensation to the executive, and the employer is neither a direct nor an indirect beneficiary of the policy), and the executive must report them as taxable compensation on his or her W-2 form. Since the executive is responsible for paying the tax on the premiums, it is common to "gross-up" compensation with an extra bonus to assist in paying the tax on the premiums. Note, however, that if the executive's salary is not "grossed-up," annual increases in policy cash values may offset the tax due. In some instances, the executive may choose to withdraw or borrow policy values to pay the tax. However, the executive should consult his or her tax professional as to the possible tax consequences of any cash withdrawal.

It's a Win-Win Situation

The executive bonus plan may be advantageous to both the business and the executive. On one hand, the business can generally deduct life insurance premiums and has total discretion in selecting not only *who* can participate, but also the *amount* of premiums and coverage to be provided. On the other hand, during his or her lifetime, the executive is free to access the policy's cash values.

Tax Benefits and Immediate Vesting

The tax-favored status of life insurance makes it well suited for use in executive bonus plans. Executives with a need for cash can simply borrow policy values down to their basis at reasonable interest rates (if the policy is not a **modified endowment contract**), without paying income taxes or the penalties on early withdrawals required by qualified plans. Access to cash values through borrowing or partial surrenders can reduce the policy's cash value and death benefit, can increase the chance that the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured. In addition, the fact that the policy isn't owned by the business gives the executive immediate vesting and 100% portability.

If the executive should die, the insurance carrier pays an income tax-free death benefit directly to the executive's chosen beneficiary. In order to prevent the policy's death benefit from being subject to estate tax, the executive may assign policy ownership to a third party and pay any gift tax due (generally on the cash value of the policy). If the executive lives for three years after the transfer and did not retain any incidents of ownership over the policy, the Internal Revenue Service (IRS) generally excludes the death benefit from the estate.

The executive bonus plan may work best in **C corporations** whose owners and executives are in a lower tax bracket than their corporations. While the executive bonus plan may not provide **sole proprietors**, **partners**, and **S corporation** owners with any tax leverage (due to the **pass-through** nature of taxation in such entities), it may make perfect sense where there is a need to attract and retain key executives.