EXECUTIVE BENEFIT ARRANGEMENTS

When working with business owners, it is important to consider the business structure in which the business operates in order to assess the suitable options available for executive benefits. Some benefit types work well in C-corporations, but not so well in S-corporations or LLCs. In addition, planning objectives such as current deductibility of contributions or having sufficient restrictions in the plan to keep the key person are also important to help narrow down suitable plans. Ease of administration is another factor.

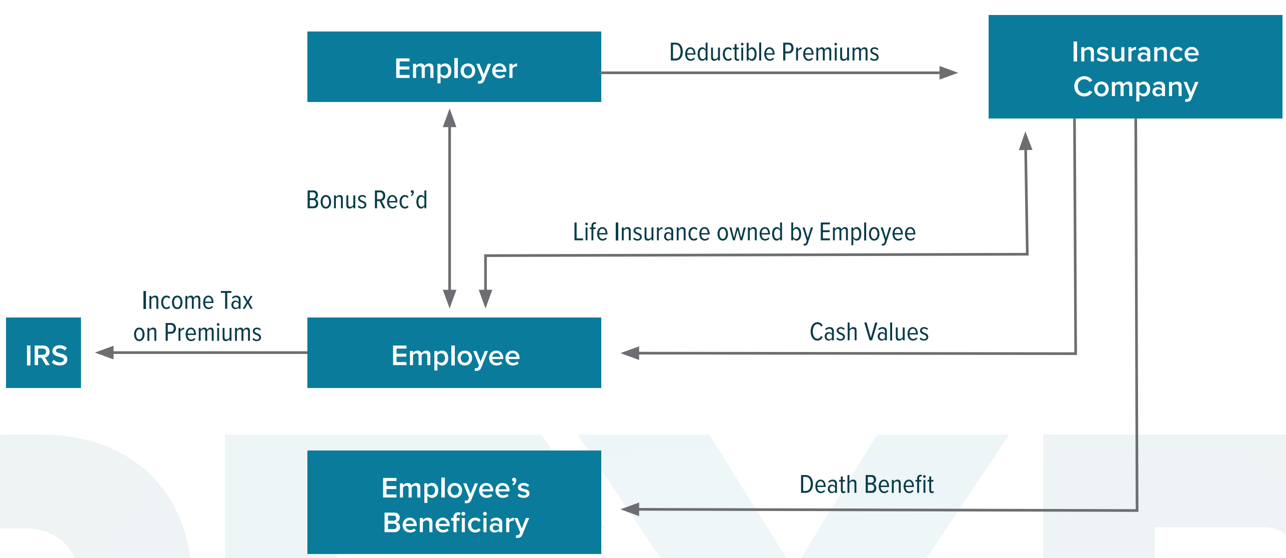
Among the options available are:

- Bonus Arrangements
- Restricted Employee Bonus Arrangements (REBAs)
- Supplemental Employee Retirement Plans (SERPs)

Executive Bonus Plan

An Executive Bonus Plan (also referred to as a "162 Bonus Plan") is a simple, low-cost way for an employer to attract and/or reward key employees—particularly in a small to midsize closely held business or any S-corporation. The employer pays a bonus to selected employees in an amount equal to the annual premium on a life insurance policy on the employee's life. The employee owns the policy and has the right to name the policy's beneficiaries. The employer may also elect to pay the taxes on the bonus for the employee (sometimes referred to as a "double bonus" from the days when the income tax bracket was as high as 50%). By paying the tax on the bonus, there is no out-of-pocket cost to the employee. The plan may be made available to both stockholder employees and nonstockholder employees. The employer can pick and choose who is to be covered under this arrangement.

How It Works:



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EXECUTIVE BENEFIT ARRANGEMENTS

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Restricted Executive Bonus Arrangement

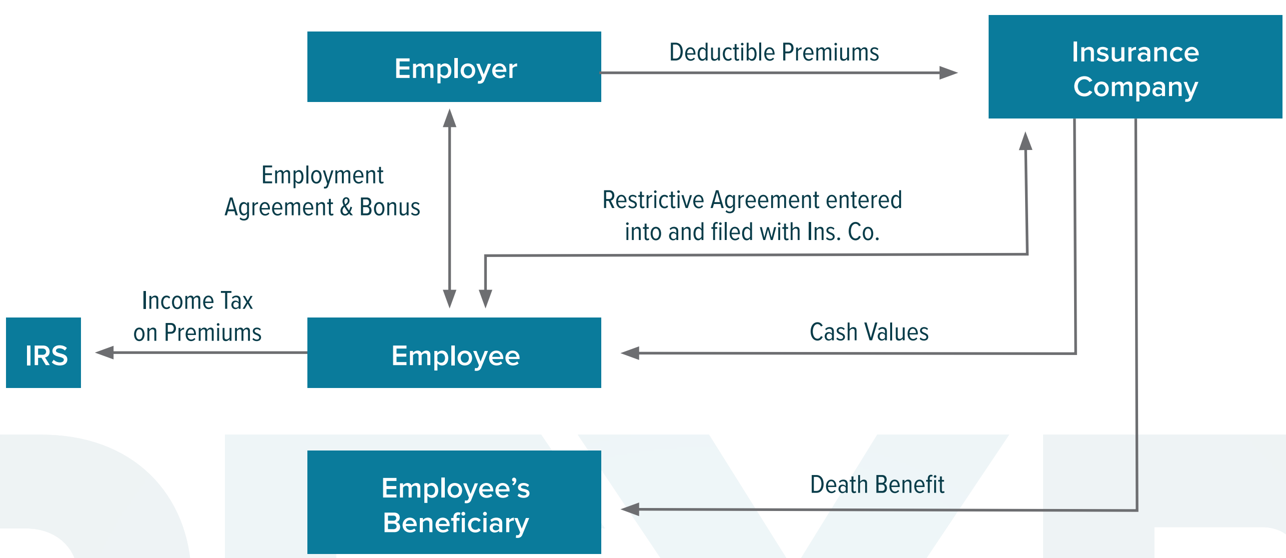
Under a restricted executive bonus arrangement (REBA), the Employer uses tax-deductible bonuses to assist the Executive in purchasing a permanent life insurance policy on his or her own life. The Executive owns the policy and names the beneficiary. Through an endorsement to the policy, the Employer is able to limit the Executive's access to the cash value.

The Employer and Employee enter into a supplemental employment agreement spelling out the terms and conditions of the restrictions designed to motivate the employee to stay with the employer for an agreed upon period of time. An endorsement is typically filed with the insurance company, restricting the executive's rights in the policy for the agreed term.

Examples of policy rights that might be restricted include surrendering the policy for its cash value, partial withdrawals of cash value, borrowing cash values, assigning the policy as collateral, or changing ownership of the policy. Though the employer controls access to the cash value by the executive, values can never revert to the employer under the restrictive agreement or the current year tax deduction could be jeopardized under Internal Revenue Section 264, which prohibits an employer from deducting premiums when it benefits from the policy.

The Restricted Executive Bonus Arrangement can, if desired, be structured to pay all the individual income taxes generated by the bonus, resulting in a zero net cost to the executive. The employer can pick and choose who is to be covered under this arrangement.

How It Works:



EXECUTIVE BENEFIT ARRANGEMENTS

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Supplemental Executive Retirement Plan (SERP)

A Supplemental Executive Retirement Plan is a non-qualified deferred compensation plan that allows employers to provide additional retirement income to key, highly compensated employers. Typically, no employee contributions or deferrals are involved.

To avoid being subject to the rules of qualified plans, including the requirement to cover all employees, the SERP must be:

- For the benefit of a select group of management or highly compensated employees. Highly compensated employees are generally no more than the top 5%-15% of the executives
- An “unfunded” plan. Basically, it is an unsecured promise by the employer to pay a lump sum or series of annual or monthly payments at some future time. The employer must book the present value of future promised benefits on the books as a liability

The employer may elect to “informally fund” the SERP with a life insurance policy. The employer is both owner and beneficiary of the policy. The cash value of the policy becomes an asset on the corporation’s books. The employer may use the policy cash values through withdrawals or loans to help pay the after tax cost of any future benefits promised at the time they are due.

The policy values are subject to the claims of the corporations’ creditors. A trust, known as a “Rabbi Trust” (because the concept was first used for a rabbi) can prevent the employer’s current or further management from touching the policy values that are assets of the trust. However, it cannot avoid the assets being subject to the claims of the corporation’s creditors.

How It Works:

1. AGREEMENT

Employer

Employer pays a retirement benefit and/or survivor benefit at death

Employer & Executive enter into an agreement

Executive/beneficiary pays income tax on retirement or death benefits received and the Employer receives a tax deduction on the benefits when they are paid

Executive

Executive receives retirement benefit and/or surviving spouse receives a death benefit

2. INFORMAL FUNDING

Employer purchases insurance policy on life of executive → **Insurance Company** → **Policy values used to pay the after-tax deductible retirement and/or death benefits as well as to recover plan costs**

EXECUTIVE BENEFIT ARRANGEMENTS

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PLAN COMPARISONS

	Bonus Arrangement	Restrictive Executive Bonus Arrangement	Supplemental Executive Retirement Plan
Employer Advantages	• The premiums are tax-deductible • The plan provides a fringe benefit to the employee • The employer may favor select employees • The plan is easy to establish and administer • No minimum or maximum number of lives must be covered • No IRS approval is needed	• The premiums are tax-deductible • The plan provides a fringe benefit to the employee • The employer may favor select employees • The plan is relatively easy to establish and administer • No minimum or maximum number of lives must be covered • No IRS approval is needed • It provides "Golden Handcuffs" through the restriction to prevent access to policy values by the employee	• It provides "Golden Handcuffs" to retain key executives or highly compensated employees • Employer owns and controls the policy • Employer may favor select highly compensated executives. If non-highly compensated employees are included, the qualified plan rules of coring all eligible employees of the employer would be invoked • No minimum or maximum number of lives must be covered • No IRS approval is needed
Employee Advantages	• The cost of the plan is paid for by the employer • Generally, the employee is owner of the policy and designates a personal beneficiary • The potential cash values of the policy may be accessed by the employee to supplement retirement income or to cover unexpected expenses on a non-taxable basis • The employee is able to take the policy if he/she leaves • The death benefit is income tax-free to the beneficiary	• The cost of the plan is paid for by the employer • Generally, the employee is owner of the policy and designates a personal beneficiary • The potential cash values of the policy may be accessed by the employee to supplement retirement income or to cover unexpected expenses after the restrictive endorsement is removed on a non-taxable basis • The employee is able to take the policy if he/she leaves after the restriction period • The death benefit is income tax-free to the beneficiary	• The cost of the plan is paid for by the employer • There is generally no current income tax incurred by the executive • Supplemental retirement benefits are available at retirement. These payments are deductible by the employer but taxable to the employee

EXECUTIVE BENEFIT ARRANGEMENTS

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PLAN COMPARISONS

	Bonus Arrangement	Restrictive Executive Bonus Arrangement	Supplemental Executive Retirement Plan
Tax Considerations	• The premiums are tax-deductible to the employer • The bonus is currently taxable to the employee • The death benefit payable to the employee's beneficiary is income tax-free • With the employee as policy owner, the death benefit will be includible in his/her estate	• The premiums are tax-deductible to the employer • The bonus is currently taxable to the employee • The death benefit payable to the employee's beneficiary is income tax-free • With the employee as policy owner, the death benefit will be includible in his/her estate	• Employer premiums are not tax-deductible (For pass-through tax entities such as S corporations and LLCs, that means premiums are currently taxable to the owners) • Employer contributions are not currently taxable to the employee • Death benefit payable to employer is income tax-free • Benefit payments deductible by employer when paid • Retirement and death benefits are taxable to employee and/or beneficiary when paid • Value of any death benefit is includible in the employee's estate
Other Considerations	• The bonus made by the employer must be considered reasonable additional compensation for the employee's position in order to be deductible under Section 162 of the Internal Revenue Code • The employer may not be named as owner or beneficiary in order for the premium to be tax deductible to the employer	• The bonus made by the employer must be considered reasonable additional compensation for the employee's position in order to be deductible under Section 162 of the Internal Revenue Code. • The employer may not be named as owner or beneficiary in order for the premium to be tax-deductible to the employer • The employer's attorney will need to draw up the employment agreement. (Insurance companies generally provide specimen wording)	• Generally, this plan is only for C corporations because of the direct tax impact to owners for other types of entities where plan contributions would be included in the owner's taxable income • In the current economy, the executive's position as an unsecured creditor of the corporation for these benefits may be of concern • The employer's attorney will need to draw up a SERP document for each employee covered • Section 409A of the Internal Revenue Code creates complex rules that require ongoing monitoring and expertise. To avoid serious penalties if 409A is violated, an experienced third-party administrator familiar with the rules should be hired by the employer

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EXECUTIVE BENEFIT ARRANGEMENTS

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THE BOTTOM LINE: The Non-owner Key Employees

Executive Bonus Arrangement

- The arrangement would be used when the Employer is not worried about the executive leaving and just wants to reward the executive and enhance the executive's death and retirement benefits
- The Employer would like to currently deduct contributions to arrangement

Restrictive Executive Bonus Arrangement

- This arrangement would be considered when the Employer wants to reward the executive but wants restrictions in place to prevent the executive from leaving early with full policy values
- The Employer would like to currently deduct contributions to the arrangement
- The Employer is a pass-through entity such as an S corporation or an LLC and does not want to impact the taxable income of the business owners. It is also feasible for C corporations who do not want to have extensive administration costs

Supplemental Executive Retirement Plan

- The Employer wants to reward a highly compensated executive but wants restrictions in place to prevent the executive from leaving
- The Employer is a C corporation with a separate corporate tax bracket
- The C Corporation has a consistently strong cash flow
- Succession strategy is in place with multiple generations of competent executives so there is some assurance that the business will still be operational through the retirement years of the executive—who is an unsecured creditor in this arrangement
- Amount of yearly outlay for "informal funding" justifies additional cost of knowledgeable

THE BOTTOM LINE: The Business Owners

Owners of Pass-Through Entities such as S corporations and LLCs

- If they do nothing, the excess earnings of the entity will be taxed to them anyway in proportion to their ownership interest
- They can pull out excess earnings in cash as salary or dividends and use the money to fund a personal insurance policy to provide supplemental income tax-free retirement benefits and an income tax-free death benefit for their family

Shareholders of C Corporations

- A bonus arrangement with no restrictions is generally the choice
- If they want to defer income and the C corporation has a strong succession plan and little chance of bankruptcy in the future, a SERP with a knowledgeable plan administrator could be considered as long as they are a minority shareholder

EXECUTIVE BENEFIT ARRANGEMENTS

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THE EXECUTIVE BENEFITS PLAN DECISION

POLICY OWNERSHIP

Employee ←→ *Employee / Vesting* ←→ *Employer*

EMPLOYER COST RECOVERY

No ←→ *Unsecured Promise* ←→ *Yes*

EMPLOYER DEDUCTIBILITY

As Funded ←→ *As Funded* ←→ *At Retirement*

PLAN ADMINISTRATION

Low ←→ *Medium* ←→ *High*

STRENGTH OF “GOLDEN HANDCUFFS”

Low ←→ *Medium* ←→ *High*

PLAN CHOICE

Bonus ←→ *Restricted Bonus* ←→ *SERP*

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