RESTRICTED EXECUTIVE BONUS ARRANGEMENT

Case Study

The Client and Concern

John Smith, sole owner of ABC, Inc., wants to provide some additional employee benefits for Mike Star, his top sales person, that can provide life insurance protection for Mike's family while also giving Mike the ability to have additional pension income at retirement to supplement Social Security and the corporation's modest 401k plan. Because ABC, Inc. is an S corporation, a deferred compensation plan does not seem to fit. John does not like the idea that the deferred compensation plan contributions for Mike would be includible in John's taxable income, since any non-deductible payments flow through to John because ABC, Inc. is a pass-through entity. However, he would like to have some strings attached to the employee benefit arrangement so that Mike is not lured away by a competitor.

The Solution

John can set up a Restricted Executive Bonus Arrangement (REBA) for Mike. If properly structured, the bonus paid by ABC, Inc. will be a deductible expense to the corporation, so it will not flow through as a taxable expense for John. John would like Mike to end up without any current taxable income tax impact, so the corporation will bonus enough to allow Mike to pay the income taxes on the bonus as well as the premium for a life insurance policy.

Through an endorsement in the life insurance policy, Mike's access to the cash value of the policy will be limited. ABC, Inc. and Mike will also enter into a supplemental employment agreement spelling out the terms and conditions of the restrictions designed to motivate Mike to stay with ABC, Inc. for an agreed period of time.

Hypothetical Numbers

Mike is age 45, in great health, and is a non-smoker. His tax bracket is 35%. John's tax bracket is 40%. They are going to use an Indexed Universal Life Policy, and the assumption is that the cash values will grow at 6%, which is not guaranteed.

		Employer			Executive					
Year	Age	Bonus	Tax Savings	A/T Cash Flow	Bonus	Taxes	A/T Bonus / Premium	Net Outlay	Cash Values	Death Benefit
1	46	(15,385)	6,154	(9,231)	15,385	5,385	10,000	0	3,602	216,368
10	55	(15,385)	6,154	(9,231)	15,385	5,385	10,000	0	107,841	316,352
20	65	(15,385)	6,154	(9,231)	15,385	5,385	10,000	0	313,401	495,815
21	66	0	0	0	0	0	0	25,763	305,242	363,237
30	75	0	0	0	0	0	0	25,763	206,267	219,631
40	85	0	0	0	0	0	0	25,763	13,947	37,167
Total		**(307,692)**	**123,077**	**(184,615)**	**307,692**	**107,692**	**200,000**	**515,260**		

Note that this is a hypothetical illustration and is not intended to predict or project actual performance of any specific policy. For any actual case, a complete illustration specific to the intended proposed insured must be used.

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Case Study *Continued*

ADVANTAGES

Employee Bonus Plan

- Premiums are tax deductible
- The plan provides a fringe benefit to the employee
- It provides a “golden handcuff” fringe benefit for select employees
- Benefits may vary between employees
- The plan is relatively easy to establish and administer
- No minimum or maximum number of lives must be covered

For the Employee

- 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
- The employee is able to take the policy if he/she leaves after restriction period
- The death benefit is income tax-free to the beneficiary

OTHER CONSIDERATIONS

- The premium and any bonus used to pay the tax bill is fully reportable as taxable income to the employee
- 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 nor have any rights to the policy cash value in order for the premium to be tax deductible to the employer
- As owner of the policy, the death proceeds will be includible in the employee’s estate (If this is an issue, there is a way to exclude it from the employee’s estate by having an irrevocable trust as owner/beneficiary, but that will tie up the cash value in the trust)
- Employer’s attorney will need to draw up the employment agreement (Insurance companies generally provide specimen wording for restrictive policy endorsement)
- The arrangement, if properly constructed, should not be required to comply with Internal Revenue Code Section 409A and its regulations. However, the employer and employee should consult with their legal counsel regarding the design of the specific arrangement and the possible consequences under Section 409A