162 Bonus Plans

Many firms are finding it harder and harder to obtain, retain, and reward key employees and executives. Using a little known technique, employers can use special benefit options to "give" employees growing cash values in the form of company-paid cash-value accumulation insurance policies. While not mainstream, these "savings programs" and disaster coverage is an effective bonus for employees while remaining a valid business deduction for employers.

I have found that the executive bonus is one of the best ways to attract and retain quality employees. The executive bonus, also called a Section 162 plan, involves the purchase of life insurance on the life of a select employee and is extremely beneficial for both the employer and employee. The employer pays the premium on the policy and includes that premium in the taxable wages of the employee. The employee (or a trust) owns the insurance, names the beneficiary and has all rights in the policy. The employer has no rights in the policy's cash values or death benefit. With the executive bonus, the employer will take an income tax deduction under Internal Revenue Code (IRC) Section 162 for the amount of the bonus, which is usually equal to the premium. The employer can pay the premium to an insurance company, to the employee or to the employee's trust. The executive bonus is often used as a supplement to IRC Section 79. Section 79 regulates employer non-discriminatory group term life insurance coverage, usually up to $50,000 per participant. The executive bonus can be added to a group term plan when the employer wants to "carve out" a select employee or a select group of employees to receive additional life insurance protection. These select employees are carved out of the Section 79 plan on a discriminatory basis. As with any executive bonus plan, the employer may deduct the premiums as compensation.

How does it work?

The executive bonus is easy to implement. The employee purchases and owns life insurance on his or her own life. The employer pays the premiums to the insurance company. The premiums are fully deductible to the employer as compensation to the employee under IRC Section 162. The premiums are taxable income to the employee, and the employee owns the life insurance policy including policy values. As the policy values grow, the employee benefits.

It has been my experience that some employers choose to pay not only the premium amount, but also the employees' tax on the premium amount. This second "bonus" pays the employee's income tax on the first premium "bonus" and creates a "double bonus plan." The employer should consider a formal resolution or document the corporate minutes to show that premium payments are intended as compensation. The employer and employee may also enter into a modification of ownership rights agreement. Even though the employee is the owner of the policy, a modification of ownership rights agreement may limit the control the employee has over the use of policy values. The employer may require that the employee is unable to access policy values for loans or withdrawals without written consent of the employer.

Who benefits?

Benefits to the employer:

• Employer selects employees

• customized benefit

• Employer receives income tax deduction

• Plan creation and implementation is easy

• No administration beyond normal payroll

• No ERISA requirements

• Premiums can be self-completing upon employee disability

• Tax deductible under Section 162

Benefits to employee:

• Employee owns life insurance and policy values

• Employee names beneficiary

• Employee can control policy use

• Little or no out-of-pocket cost

• Source of supplemental retirement income

• Proceeds may be used for estate costs

Last but not least

• Employer payments are wages to the employee and are subject to FICA and FUTA.

• Since the employee has paid tax on the premiums, he or she has a cost basis equal to the sum of the paid premiums. This can be used to offset income tax as amounts are withdrawn or if the policy is surrendered.

• A sole proprietor may not deduct life insurance premiums on his or her own life. Such premiums are nondeductible personal expenses. IRC Section 262. A sole proprietor may however deduct premiums on an employee of the sole proprietorship. IRC Section 162.

• The employer cannot take a deduction for premiums when the employer is a beneficiary of the policy. IRC 264(a)(1).

• An employee's "reasonable" compensation is deductible by an employer. Reg. 1.162-7(b)(3). When compensation exceeds what is customarily paid for like services, the deduction may be denied. Compensation that is found to be unreasonable by the IRS may be reclassified as a dividend if paid to the employee shareholder. Reg. 1.162-7 (b)(1).

• No deduction is permitted for "applicable-employee remuneration" in excess of $1 million paid to any covered employee by any publicly-held corporation. IRC Section 162(m)(1). This may not apply to commission payments that are based on the employee's performance.