



An executive bonus plan, also known as an IRC §162 arrangement, is a method for a business to reward specific employees with a bonus to cover the cost of their life insurance policy. These arrangements can assist businesses in attracting high-quality employees by offering an additional benefit of employment to complement their qualified plan and group term offerings.

CASE STUDY

- Enrique is a top executive at Technology Manufacturers of America (TMA) and was offered an executive bonus arrangement that includes an additional bonus for his income tax liability.
- The double bonus includes his applicable ordinary income tax, payroll taxes, states, tax, and local tax rates, which equate to 45%
- Enrique’s permanent life insurance policy premiums are \$13,750 a year
- In order for TMA to determine the extra bonus needed to cover Enrique’s tax liability, it would $\$13,750 \text{ annual premium} \div 0.55 (1 \text{ minus } 0.45)$.
- The total executive bonus for Enrique each year would equal \$25,000
- This double bonus will cover the 45% tax Enrique will pay on the \$13,750 bonus he receives for him to pay his permanent life insurance policy.

Benefits to the Business	Benefits to the Employee
<ul style="list-style-type: none"> • Bonuses used to pay premiums are an ordinary and necessary business expense to the extent it is reasonable and will be tax deductible to the business under IRC §162. • Because this is an arrangement between the business and the employee, the IRS does not need to preauthorize it or require disclosure and annual reporting. • Because this is not a qualified plan, there are no annual administrative cost to the business, the bonus is handled through normal payroll services, and the business can select the employees to whom they offer this benefit. • These kinds of arrangement can help the business recruit and maintain top talent in their industry. 	<ul style="list-style-type: none"> • Since the employee is the owner of the life insurance policy and assuming premium payments are met, it will stay with them even if they leave the company. • Double bonus arrangements cover the tax liability to the employee. • Since the employee is the owner of the permanent life insurance policy, he or she has access to the cash value and can borrow* from the policy. • The employee chooses the beneficiary, anyone other than the business, who receives the death benefit generally free of income tax.

RESTRICTED EXECUTIVE BONUS ARRANGEMENT (REBA)

Some businesses may wish to maintain greater control over the executive bonus arrangements they make with employees. A Restrictive Executive Bonus Arrangement (REBA) establishes certain limitations for the employee during their employment. The employee retains ownership of the permanent life insurance policy, while the business covers the premiums. However, this type of policy includes a special endorsement that necessitates the employee seek the employer's approval before borrowing or withdrawing cash value, surrendering the policy, using it as collateral for a loan, or changing the ownership. It's important to note that this special endorsement does not grant any ownership rights to the business. A REBA typically indicates when these restrictions will be lifted, whether upon retirement, disability, reaching a certain age, or once the employer signs a waiver and release.

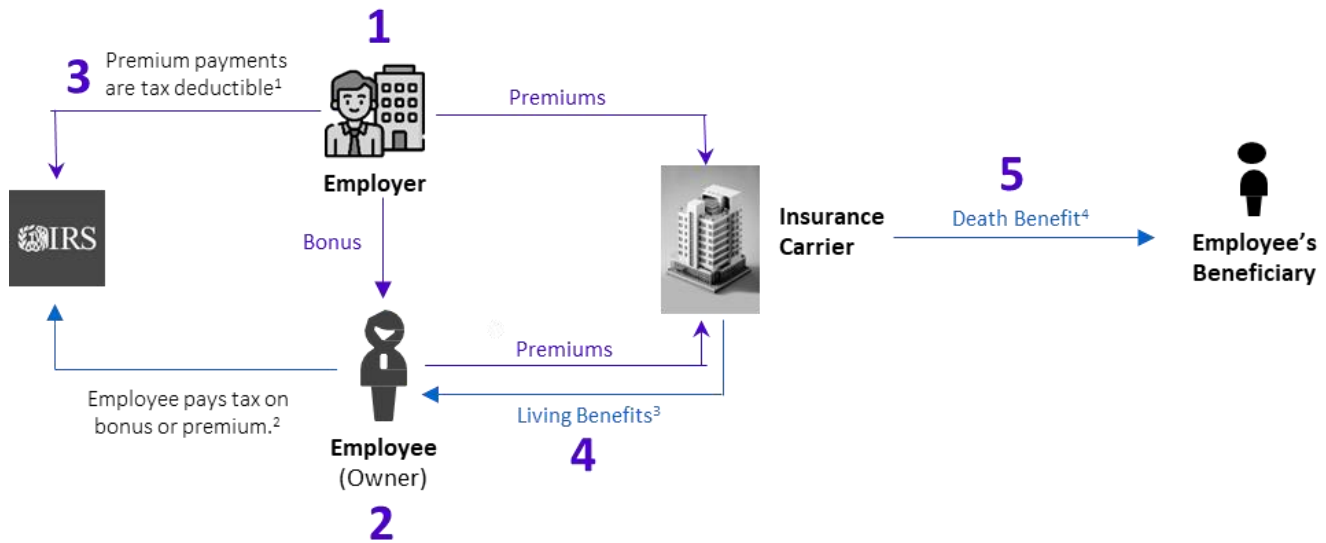
Typically, the business will also have a separate agreement with the employee outlining what will happen if the employee leaves the business before retirement, potentially requiring the employee to repay all or a portion of the bonuses received. Once the restricted period is over, the business must notify the life insurance company in writing to remove the special endorsement on the policy.

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How Executive Bonus Arrangements Work



1	The employer selects the employee(s) it wishes to benefit and pays annual premiums on a life insurance or disability policy, either directly or by way of a cash bonus to the employee.
2	The employee reports bonus or premium payments as additional compensation and pays taxes on that amount each year.
3	Premium payments are tax deductible to the employer as an ordinary business expense as long as the employee's total compensation is considered reasonable.
4	At the employee's disability or qualifying health event, he or she receives disability or living benefits from the insurance policy. Disability benefits are free of federal income tax. Living benefits (accelerated death benefits) are free of federal income tax in most instances. ³ Disability / living benefits may be free of federal income tax.
5	At the employee's death, his or her beneficiary receives the death proceeds free of federal income taxes under IRC Section 101(a). ⁴

¹ Premium payments are tax deductible as long as the employee's total compensation is reasonable.

² Employee pays the tax on the bonus or premium payments. The employer may double the bonus the amount to cover the tax liability for the employee.

Loans, withdrawals, and death benefit accelerations will reduce the policy value and death benefit and may increase the chance of the policy lapsing. Provided the policy is not and does not become a modified endowment contract (MEC), 1) withdrawals are tax-free to the extent that they do not exceed the policy basis (generally, premiums paid less withdrawals) and 2) policy loans are tax-free as long as the policy remains in force. If the policy is surrendered or lapses, the amount of the policy loan will be considered a distribution from the policy and will be taxable to the extent that such loan plus other distributions at that time exceed the policy basis.

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