

Business Strategies and Ideas

Executive Bonus Plans: Rewarding Employee Performance

Rewarding employee performance helps strengthen the stability of a business and helps reduce turnover among the ranks of valuable employees. Losing an important employee to a competitor can disrupt current and future business profitability.

Privately-held business entities have limited options when designing compensation packages for their employees. Many small companies are unwilling to establish qualified retirement plans because of the high cost of the plans and because they have to include all eligible employees.

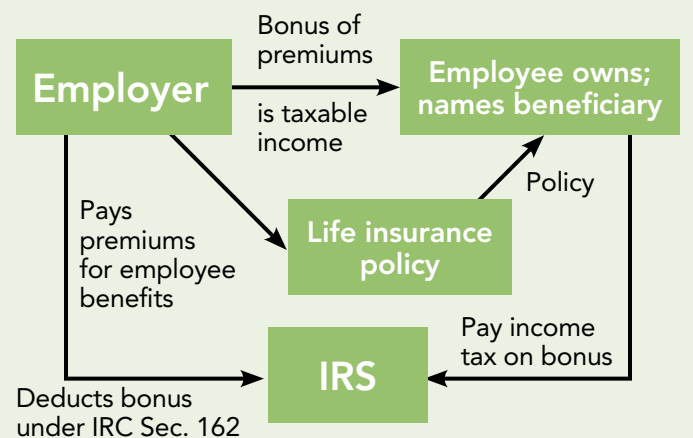
Nonqualified deferred compensation plans are an option but participation is restricted to certain highly paid management employees. Having benefits in addition to normal compensation is a proven method for improving employee morale and job satisfaction and thereby reducing costly employee turnover.

An Executive Bonus Plan (also known as a Section 162 plan after the section of the Internal Revenue Code that permits an employee to deduct compensation paid to employees) offers the opportunity to reward any employee. It could be a one-off bonus for exceptional work in any year or, more commonly, an on-going arrangement to provide additional compensation annually. To enhance the future value to the employee and the employee's family, the payment is usually paid as the premium for a cash value life insurance or annuity contract owned by the employee.

Attaching conditions, such as job performance or continued employment, to the right to continue receiving this additional compensation increases the attractiveness of such a plan to the employer and further increases the likelihood that the employee will remain with the company.

These restrictions are often referred to as “golden handcuffs” and such plans are known as “Restrictive Executive Bonus Arrangements.” The illustration below shows how an Executive Bonus Plan works.

The Executive Bonus Plan



True cost of benefit to the key employee is the additional income tax

The employee is responsible for payment of income tax on the bonus paid by the employer. In some cases, the employer will pay an additional amount to cover the associated income tax liability in which case the plan is known as a “double bonus” plan.

As long as the bonus represents “reasonable compensation,” the business can deduct the bonus used to pay the life insurance policy premium. The employee owns the life insurance policy and names his or her beneficiary.

An employer can place certain restrictions on the policy as an incentive to the insured employee to remain with the company. One such restriction can be limiting access to policy cash values by the employee for a selected period of time, such as until the employee’s expected date of retirement.

Additional Considerations

Employers should seek legal counsel regarding creating a formal agreement between the employer and the employee governing the Executive Bonus Plan. Any corporate records notation or agreement should spell out who will participate in the executive bonus program, why such employee or employees were selected for participation, and the nature of the benefit these employees will receive.

Any restrictions on an employee’s right to access insurance policy cash value, or any “golden handcuffs” arrangement, should be spelled out in the written agreement between employer and employee.

Any restrictions on the policy itself, such as limiting the employee’s access to cash value, will be detailed in the agreement which is filed with the insurance company. The agreement will indicate the time period during which policy restrictions will remain in effect, and list the conditions for removal of any restrictions on the employee’s access to the policy.

The purposes of a permanent cash value life insurance Executive Bonus Plan include growing funds on a tax-deferred basis to be made fully available to the employee for supplemental income in retirement.

From an employee’s perspective there are two concerns with this type of arrangement. If this is not a “double

bonus” plan, the employee may be concerned about having the funds to pay the income tax liability. Also the employee may be concerned about the viability of the life insurance contract if the employer does not pay the bonus each year. To address some of these concerns, the employer and employee could agree to establish the plan for a limited period and make payments in an amount sufficient to sustain the policy after the payment period.

With a properly structured executive bonus plan, both the employer and employee win. The employer benefits from greater employee loyalty and lower staff turnover; the employee benefits from expanded compensation options.

Bonus Plan Benefits

Benefits to the Employer:

- A current income tax deduction for compensation paid and a benefit provided to the employee
- Employer can discriminate in selecting the employees who will receive the benefit
- Employer can establish performance goals that must be reached for the employee to receive bonus
- Easy to install and administer
- Helps to retain valued employees

Benefits to the Employee:

- A cash bonus is provided to cover cost of permanent life insurance coverage
- Employee’s out-of-pocket cost is limited to income tax owed on the bonus paid
- Insurance policy cash value grows tax-deferred to provide supplemental retirement income
- Additional family protection is provided in the event of a premature death
- Employee owns the life insurance policy and names policy beneficiaries

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