WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: 162 Bonus Plans – The Basics.

MARKET TREND: As the economy improves, employee talent is at a premium. 162 bonus plans can create a competitive edge to attract or retain key employees by using employer-funded life insurance policies.

SYNOPSIS: Employers create 162 bonus plans to provide supplemental benefits to select key employees. Generally, the plans use life insurance, funded by the employer's bonus payments, to provide the insured employee with access to policy cash value if needed for retirement or other purposes and death benefit protection for the employee's family. While the employee receives the bonus payments as taxable compensation income, the employer can take a corresponding deduction for the payments. From the employer's perspective, these plans also are typically subject to less complex tax rules and ERISA regulations than other nonqualified deferred compensation plans.

TAKE AWAYS: 162 bonus plans may make sense for employers looking to attract and retain key employees or provide carve-outs from group-term life insurance programs, particularly for younger key employees in lower tax brackets who likely have insufficient insurance coverage. Employers may appreciate the relative ease of implementing and administering these plans, while employees can benefit from access to cash values if needed for retirement or other purposes and death benefit protection.

Key employee bonus plans, commonly referred to as "**162 bonus plans**[1]" can offer a simple and flexible option for providing benefits to attract or retain key employees through the purchase of life insurance. The insurance-funded bonus plan allows the employee to set aside additional funds that could be accessed if needed for retirement or other purposes, provide death benefit protection to family members, and establish estate liquidity.

WHAT IS A 162 BONUS PLAN

A 162 bonus plan is an arrangement where the employer effectively funds an employee's purchase of life insurance through the payment of bonuses to the employee or possibly through

direct payment to the issuing carrier. The employee (or the employee's irrevocable life insurance trust "**ILIT**") acquires and owns all rights in the policy. The employer in a 162 bonus plan does not anticipate reimbursement of any premiums paid, is not a direct or indirect beneficiary of the policy, and never owns an interest in the policy.

WHY USE A 162 BONUS PLAN

Potential Employer Benefits

- *Deductibility of Bonus Payments*. As discussed below, the employer generally can take a current deduction for bonus payments under the plan.

- *Ease of Implementation/Administration*. A 162 bonus plan is relatively easy to implement and administer, especially as compared to other non-qualified employee plans.

- *Administrative Flexibility*. In most instances, a 162 bonus plan is not considered a "qualified plan" under the Code or ERISA, which would require compliance with various nondiscrimination rules. Thus, the employer has significant flexibility to choose the covered key employees, to decide the amount and duration of the bonus, to offer plans with different terms or benefits for various employees, and to vary the types of insurance policies covered.

- *No IRS Consent*. The employer does not need to obtain IRS consent to implement or terminate a 162 bonus plan.

- *Key Employee Retention*. The company may impose certain terms in the plan agreement or restrictions on the policy through a "restrictive endorsement benefit arrangement" or "REBA" to incentivize the employee to remain with the company.[2]

Potential Key Employee Benefits

- *Customizable*. 162 bonus plans can be tailored to the selected employee, based on an employee's individual need for permanent life insurance benefits or post-retirement needs.

- *Management of Income Tax Impact on Employee*. The income tax impact to the employee can be minimized if the employer agrees to "gross-up" the bonus payments to cover the employee's anticipated tax liability thereon.

- *Sole Ownership*. The key employee (or ILIT) will solely own the policy, allowing the employee to control or retain the policy during and after employment, subject to any REBA.

- *Cash Value Growth, Access and Death Benefits*. Under appropriate and long-standing tax laws and principles, the cash value growth within a life insurance policy generally is not subject to income tax and policy beneficiaries receive the policy death benefits imposition to income tax, and possibly without estate tax if the policy is held in an ILIT. Cash value generally can be accessed through policy loans and/or withdrawals (up to policy basis), without imposition of income tax.[3]

WHEN A 162 BONUS PLAN MAY MAKE SENSE

Common scenarios for the use of 162 bonus plans including the following:

- For employers looking to attract and retain key employees without the compliance and administrative complexities of Internal Revenue Code ("**Code**") §409A. A 162 bonus plan can offer benefits to key employees without triggering Code §409A.

- As key employee carve-outs from group-term life insurance programs.

- For companies looking for alternatives to qualified plan benefits, such as in a small business setting where qualified plans may be too expensive.

- For closely-held businesses with non-owner key employees, where the plan can provide employee benefits without impacting ownership or control of the company.

LIFE INSURANCE CONSIDERATIONS

A 162 bonus plan can be funded using a variety of insurance policies, although permanent life insurance products may be preferred because of the availability of cash value for various employee needs.

> ***Example:*** B is a single, 44-year old key employee of XYZ, Inc. XYZ agrees to a 162 bonus plan that provides B with a gross-up bonus so B will not be out of pocket for any tax liability. B uses the bonus to purchase a permanent, cash value policy on his life.[4] B retires at age 65, when the policy's cash value is $800,000. B can access that $800,000 through withdrawals (up to policy basis) and/or policy loans if needed for retirement or other purposes, without imposition of income tax.

The employee also may seek to use cash value or policy dividends to offset his or her tax liability from the plan (if a gross-up bonus is not used). If a spousal lifetime access trust (or "**SLAT**") owns the policy, the trustee may be able to access the cash value for the benefit of the key employee's spouse while allowing the policy death benefits to remain outside of the employee's estate.

TAX IMPLICATIONS

Income Tax

Employee. The bonus is ordinary income to the key employee and taxed at his/her normal income tax rate.[5] Over time, this tax liability may become a concern, particularly if the employee has liquidity issues. In some cases, employers may be willing to use a gross-up bonus to address the issue. Other alternatives include having the employee obtain a commercial loan, which eventually can be paid back from other assets or policy death benefits, or having the employer itself to make a loan to the employee.[6]

Otherwise, any lifetime benefits taken from the policy (e.g., withdrawals or policy loans) are treated and taxed for income tax purposes as if the employee (or his or her ILIT) purchased the policy directly (*see WRMarketplace No.14-31* for a discussion of the income tax rules applicable

to life insurance policies and policy owners). The policy death benefits paid to the policy beneficiaries upon the employee's death should not be subject to income tax.[7]

Employer. Typically, the employer can take an income tax deduction for bonuses paid under the 162 bonus plan, provided the payments constitute compensation to the key employee that, when combined with the employee's other compensation, is reasonable, and the employer is not directly or indirectly a beneficiary of the policy.[8] Because a bonus is treated as wage income, it is subject to both FICA and FUTA withholding.[9]

Transfer Taxes. Generally, death benefits payable under the life insurance policy funded through a bonus plan will be taxable in a deceased employee's estate if the employee has any incidents of ownership at the time of death (or within three years prior to death).[10] If a properly structured ILIT acquires and holds the policy, the estate tax exposure may be eliminated. However, the employee will be deemed to make a gift to the ILIT of each bonus amount received, to the extent the bonus covers the premium on the ILIT's policy.[11]

NOTE ON REBAs

As noted above, an employer may want to structure the 162 bonus plan as a REBA, which typically requires the key employee to stay with the company for a specified period of time. The REBA will include certain restrictions -- for example, the employer may require the employee to repay bonuses if employment is terminated before the specified date, and/or the employer may seek a restrictive endorsement to the policy, which requires the employer's consent if the employee seeks to surrender the policy or access its cash value before the specified date. Depending on its terms and structure, however, a REBA may not provide the anticipated results regarding tax consequences or ERISA. Thus, employers contemplating REBAs should consult with their tax and legal advisors before creating any such arrangement.

ERISA AWARENESS

Depending on the structure, a 162 bonus plan may be exempt from all or most of the restrictions imposed by ERISA on welfare and pension plans.[12] The arrangement may not constitute a plan for purposes of ERISA if the employee voluntarily decides to use the proceeds to purchase a life insurance policy. But the arrangement might be considered a welfare plan if the employer directly pays a premium to an insurance company on the employee's behalf or structures the bonus arrangement in a way that creates an expectation that the company bonus is to be used to fund a policy. In addition, the arrangement might be considered a pension plan if it is deemed to have been established primarily to provide retirement income (perhaps because of cash values relative to death benefit or through the use of vesting schedules). Again, employers should consult with their tax and legal counsel to review these issues prior to implementing a 162 bonus plan.

MECHANICS

Steps for an employer to take when creating and implementing a 162 bonus plan include the following:

- Consult with tax and legal advisors regarding the appropriate structure and terms for the arrangement, including a review of the ability to impose restrictions or other obligations on the participating key employee.

- Determine the amount of the bonus that the employee will receive and whether a gross-up bonus will be used to limit the employee's tax obligation.

- Pass a company resolution that identifies the business purpose for the 162 bonus plan and its potential benefits to the company, identifies the participating key employee, and authorizes the plan expenditures as appropriate and reasonable in light of the expected benefits to the business and the overall compensation of the participating employee.

- Although not required, the arrangement's terms should be documented in an agreement between the employer and the participating employee, including the bonus amount, type (e.g., whether to use gross-up bonus) and duration, how the bonus will be paid (to the employee or directly to the carrier), any restrictions on or requirements for the employee to remain eligible for the bonus plan. The agreement may identify the type of policy or range of benefits that the employee may acquire.

As the key employee (or his or her ILIT, if applicable) will buy and own the life insurance policy, they should coordinate directly with the life insurance advisor to apply for the desired coverage.

TAKE AWAYS

- 162 bonus plans may make sense for employers looking to attract and retain key employees or provide carve-outs from group-term life insurance programs, particularly for younger key employees in lower tax brackets who likely have insufficient insurance coverage.

- Employers may appreciate the relative ease of implementing and administering these plans, while employees can benefit from access to cash values if needed for retirement or other purposes and death benefit protection.

NOTES

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[1] This name refers to Internal Revenue Code § 162(a)(1), under which an employer sponsoring a bonus plan can deduct the bonus amount to the covered employee as a "ordinary and necessary business expense" (e.g., reasonable compensation).
[2] Also sometimes referred to as "restrictive executive benefit arrangements." See discussion *infra* regarding certain considerations in using REBAs.
[3] Assuming the policy is not a modified endowment contract ("**MEC**").
[4] Assumes the policy is not a MEC.
[5] *See* Code § 61; Treas. Reg. §1.61-1(a).
[6] If the loan given by the employer has a below-market interest rate, the employee may have additional imputed income subject to tax. Code §7872.
[7] *See* Code §101(a)(1).
[8] *See* Code §162(a); Rev. Rul. 58-90.
[9] *See* Code §§ 3121(a) and 3306(b)(6).
[10] *See* Code § 2042; Code § 2035.
[11] If the ILIT provides "Crummey" withdrawal powers to the ILIT beneficiaries, then the key employee's annual gift tax exclusions may be available that can address a potential deemed gift. However, if the ILIT holds the policy and no other assets, there may be a question as to whether the Crummey powers provide a present interest for annual gift tax exclusion purposes if the ILIT trustee can only satisfy potential withdrawal demands from cash contributions (*see e.g.*, PLR 8126047 and PLR 8103074). The trust agreement may avoid this issue if it allows the trustee to satisfy withdrawal rights through distributions of cash, other property (including a fractional interest in a life insurance policy), or even borrowing against an insurance policy's cash value (see e.g., PLR 8021058 and PLR

8006109). Yet, older private letter rulings have held that Crummey powers satisfied the present interest requirement even though the trusts held only term or group term life insurance policies lacking cash value (see e.g., PLRs 8118051, 8006109, 8006048, 7947066, 7935091, and 7826050). Ideally, for annual exclusion qualification, the ILIT would provide the Crummey power holders with an absolute right of withdrawal with regard to a transfer to the ILIT (with or without receiving notice), broadly define what constitutes a "contribution" to the trust for Crummey power purposes (e.g., any direct or indirect transfer that is deemed a gift), and allow the trustee to satisfy exercised powers by distributing any ILIT asset (or fractional interest therein) or by borrowing.

[12] Note that bonus plans may constitute "welfare benefit plans" for ERISA purposes and thus be subject to ERISA's reporting and disclosure requirements, fiduciary requirements and administration and enforcement provisions, unless an exemption applies. Bonus plans that benefit a small group of employees or are structured as "top-hat" plans may qualify for an exemption to many of these ERISA requirements.

DISCLAIMER

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