

Executive Bonus

Traditional and Restricted Executive Bonus Arrangements



PACIFIC LIFE

Pacific Life Insurance Company

How Life Insurance May Be Used To Reward Key Executives



Behind the success of every business, there are great executives.

As a business owner, your key executives are an important factor behind your business's success. So isn't it time to show them your appreciation? Rewarding your key employees with an executive bonus arrangement using life insurance, which primarily provides death benefit protection, may be an effective way to achieve that goal. It's also a way you can help ensure that your top performers work for you and not a competitor.

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What are the benefits and considerations of an executive bonus arrangement using life insurance?

For the employer:

- **Tax-deductible bonuses.** Bonuses that assist executives with paying the premium on their life insurance policy may allow for an immediate tax deduction unlike deferred compensation plans.¹ The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a).
- **Simple.** Since an executive bonus arrangement is not considered a split-dollar arrangement or nonqualified deferred compensation plan, there is no need to decipher or comply with the final split-dollar regulations or Internal Revenue Code Sections 101(j) or 409A.
- **Minimal costs.** Little to no administrative costs since a third party administrator is not necessary.
- **Selective participation.** You select the executives who will receive the benefit. There are no minimum participation requirements.
- **Control.** You determine the bonus amount and the number of years it is to be provided.
- **No Department of Labor (DOL) pre-approval required.** Because an executive bonus arrangement is not intended to be a qualified plan, it may be established, administered, and terminated without approval from the DOL.²

Considerations:

- The employer generally cannot recapture the bonuses given to the executive.

Who is a potential candidate?

- Owner and non-owner executives of C-Corporations
- Non-owner executives of pass-through entities such as S-Corporations, partnerships and limited liability companies
- Employers who want to recruit, reward, and retain key employees
- Employers who want to offer benefits in excess of those offered by their qualified retirement plans

¹ Deferred compensation plans are not deductible until benefits are taxed to the executive, usually resulting in delayed tax deductions for the employer. (See IRC Sec. 83(h)).

² Please consult with your employee benefits legal counsel as to whether this is an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) and if so, whether any additional requirements are necessary to comply with ERISA.

For the executives:

- **Tax-free death benefit.** In the event of the executive's passing, the death benefit proceeds paid to the executive's beneficiary are received federal income tax-free.³
- **Supplemental income.** The policy's cash values accumulate in a tax-deferred manner. The executives may withdraw or borrow from their available policy cash value.⁴
- **Portability.** The life insurance policy is portable should an executive separate from service from the employer. The executive may institute the same design with a new employer.
- **Income-tax liability.** Although the bonus is taxable to executives, it can be structured to pay both the policy premium and the income taxes generated by the bonus, resulting in a zero net cost to the executive.
- **Creditor protection.** Because the insurance policy is owned by the executive and is generally not an asset of the business, it may be beyond the reach of the business's creditors. Whether the executives' life insurance policy is protected from their creditors may depend on state law and the court's perception of the debtor's purpose in holding the life insurance.⁵

Considerations:

- The executives must recognize the bonus payments as taxable income.
- Unless additional planning is done, the death benefit of the policy will be included in the executive's estate.
- If an executive separates from service, or the arrangement is terminated, he or she will have to pay any future premiums or the policy may lapse.

Using executive bonus for business owners:

Business owners may want to use business dollars to help fund a life insurance policy for death benefit protection and as a source of supplemental retirement income for themselves.

In general, structuring the payment as a bonus to an owner of a pass-through entity (e.g. partnership, S-Corporation, or Limited Liability Company) may result in no income tax advantage to the business owner, and in some situations, may be tax adverse.⁶ A bonus to an S-Corporation owner is subject to payroll taxes, whereas a K-1 distribution of pass-through income to the S-Corporation owner is not subject to payroll tax. Depending on the owner's basis in the company the distribution may or may not be subject to income tax. It is important to consult with the client's tax advisor to determine the owner's basis.

Using an executive bonus arrangement for a business owner may make sense for the minority-owner of a pass-through entity. A pass-through business with multiple owners may want to give a greater share of revenue in the form of a bonus to minority owners than the share to which they would ordinarily be entitled according to their pro rata distributive percentage.

³ For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

⁴ Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

⁵ State law may provide life insurance and annuities with certain asset protection benefits. As a general rule, a debtor may not transfer property with the intent to avoid debt due to his creditors. The laws governing asset protection, however, are complex and the consequences of poor planning may be both civil and criminal penalties. Anyone contemplating an asset protection plan should not undertake such without the advice of legal counsel.

⁶ A pass-through owner may use business dollars to pay a bonus to themselves, and although the business may receive a tax deduction, the bonus is subject to income tax as well as employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Medicare). As opposed to other pass-through owners, S-Corporation owners may avoid employment taxes on K-1 Distributions; as such, they will generally take only a reasonable salary as W-2 income. (See IRS Form K-1).

How an executive bonus arrangement works

The employer provides a cash bonus to the executive, who then uses the bonus to purchase a life insurance policy. The employer can design the bonus arrangement to give the executive the option to take the bonus in cash and then in turn pay the life insurance premiums, or have it paid directly to the insurance company to fund the life insurance premiums. Even if bonuses are paid directly to the insurance company, the executive is still the owner of the policy and names the beneficiary of the policy's death benefit. Regardless of the structure of the bonus, the executive will be taxed on the full bonus amount.

If the bonus design does not place restrictions or reversions on the bonused amounts, the only documentation generally required is a corporate resolution that will be prepared by the employer's legal advisor. Generally, there isn't a formal written agreement between the employer and the executive. The corporate resolution establishes the purpose for the bonus such as helping to recruit, retain, and reward key executives. This is important in order to document that the bonused amounts are a reasonable business expense of the company, thereby preserving the tax deduction.

TAX ISSUES

How may the payment of an executive's bonus be tax deductible by the employer?⁷

- If the bonus is an ordinary and necessary business expense, paid or incurred in the taxable year while carrying on a trade or business.
- Payment must also be made "in good faith as additional compensation for services rendered, and provided that the payment, when added to the stipulated salaries, does not exceed reasonable compensation for the services rendered."⁸
- Payment must be for services rendered and, therefore, bonuses to non-executive shareholders would be considered non-deductible dividends.

PLANNING APPLICATIONS

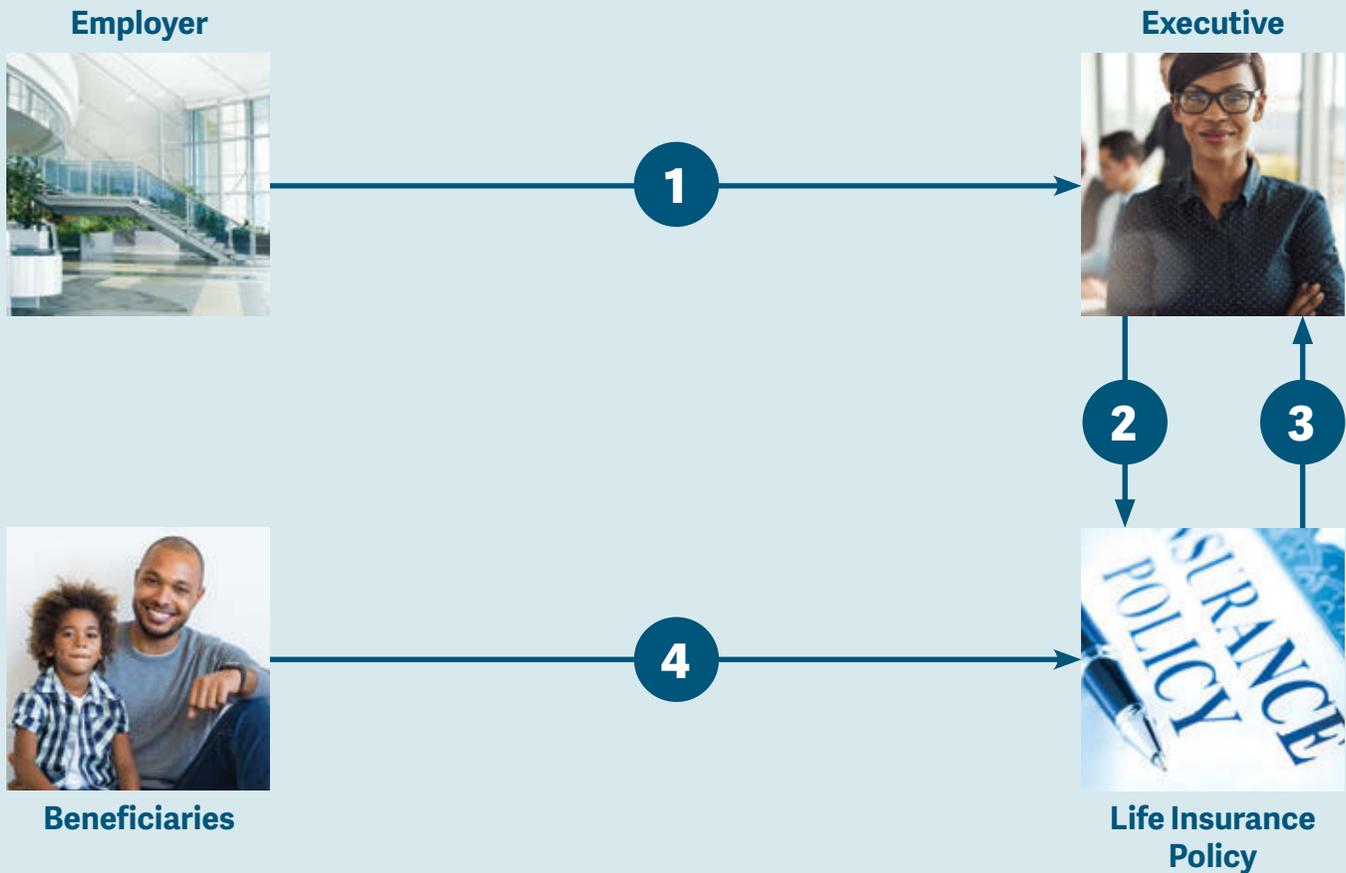
May an executive's bonus arrangement provide the executive with security?

- A key executive may not be comfortable with the insolvency risk associated with a deferred compensation arrangement. In an executive bonus arrangement, the insurance policy is portable and personally owned by the executive. Therefore, the policy may be beyond the reach of the business's creditors, giving the executive the additional security desired.



⁷ The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a).

⁸ Treas. Reg. Sec. 1.162-9



1 TAXABLE BONUSES

The employer agrees to assist the executive with the purchase of a life insurance policy through a series of taxable bonuses. The bonuses are potentially tax-deductible for the employer⁹ and may be “grossed-up” to help reimburse the executive for income taxes generated as a result of the additional compensation.

2 PREMIUM PAYMENTS

The executive uses the bonuses to purchase a personally-owned life insurance policy. The executive maintains complete ownership of the policy and names the beneficiary of the policy’s death benefit.

3 POLICY DISTRIBUTIONS

The executive may access the available cash value of the life insurance policy through loans and withdrawals for emergencies or other financial needs.¹⁰

4 DEATH BENEFIT

At the executive’s death, the life insurance proceeds will be paid to the executive’s beneficiaries income tax-free.¹¹

⁹ The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a).

¹⁰ Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

¹¹ For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the “transfer-for-value rule”); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

The employer has no control over what the executive does with the money in a traditional executive bonus arrangement. How do you create an incentive program that ties the employee to the company using “golden handcuffs?”

How a restricted executive bonus arrangement (REBA) works

With a restricted executive bonus arrangement, the employer can delay the executive’s access to the policy’s cash value (through the use of a restricted executive bonus direction form). This restriction remains in place until the executive meets the access requirements of a restricted executive bonus agreement which the executive and the employer enter into separately from the direction form. Once the employer makes the bonus payments, however, the payments will never revert back to the employer. By structuring the arrangement this way, the issues surrounding the potential loss of the employer’s deduction and ERISA compliance may be minimized.

The restricted executive bonus direction form

The restricted executive bonus arrangement is similar to a traditional executive bonus arrangement using life insurance. There are, however, two additional components:

- 1 A written restricted executive bonus agreement prepared by the employer’s legal advisor, and;
- 2 A restricted executive bonus direction form.

With a restricted executive bonus, the executive is the owner of the insurance policy. A restricted executive bonus direction form is filed and instructs the insurance company that the executive must obtain the signature of the employer in order to exercise any ownership rights other than naming or changing the beneficiary. By completing this form, the employer can control when distributions from the life insurance policy will be made to the executive. It is important to reiterate that in a

ERISA ISSUES

How is a restricted executive bonus arrangement treated under ERISA?

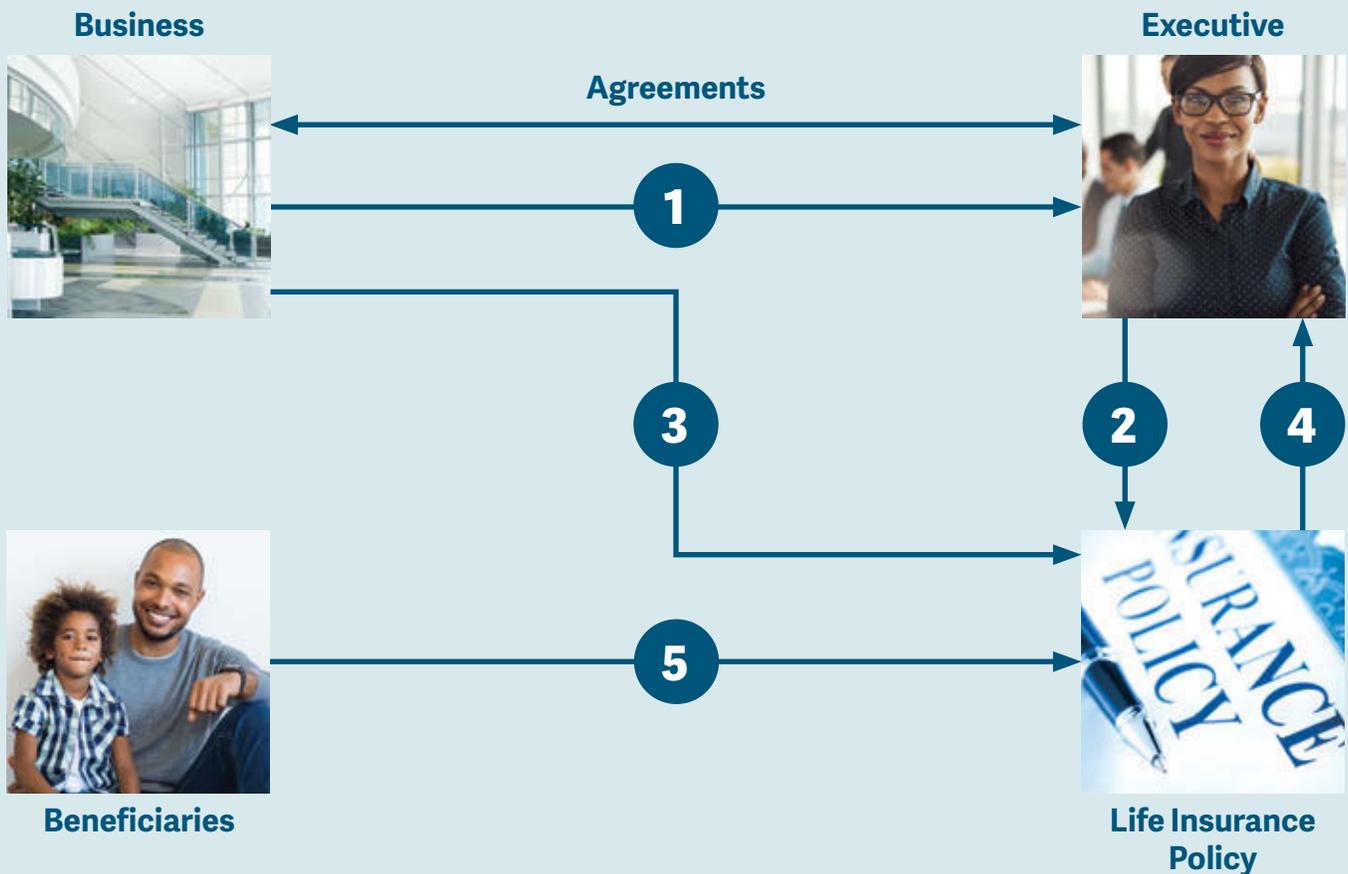
- Because a restricted executive bonus arrangement does not involve deferral of income it is often treated as either a pure cash bonus or a welfare benefit plan under ERISA.¹²

restricted executive bonus arrangement, cash values or death benefits never revert back to the employer. The only control the employer retains is the ability to delay policy distributions to the executive.

When and how the policy restrictions are released by the employer is dictated in the restricted executive bonus agreement that is prepared by the employer’s legal advisor, whereby the employer and executive agree to a “restricted access schedule.”

Generally, the policy restrictions will remain in place for a specified number of years, or until a specified age. If the executive terminates prior to the date that is outlined in the agreement, the policy restrictions stay in place and the executive would be unable to ever access any of the policy’s cash value. In such a case, however, the executive is still entitled to the death benefit.

¹² Please consult with your employee benefits legal counsel as to whether this is an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) and if so, whether any additional requirements are necessary to comply with ERISA.



- 1 TAXABLE BONUSES** The employer enters into an agreement with the executive to assist with the purchase of a life insurance policy through a series of taxable bonuses. The bonuses are potentially tax-deductible for the employer.¹³
- 2 PREMIUM PAYMENTS** The executive uses the bonuses to purchase a personally-owned life insurance policy. The executive names the beneficiary of the policy's death benefit.
- 3 DIRECTION FORM** A restricted executive bonus direction form is filed with the life insurance company that issued the policy. The direction form states that the exercise of any policy ownership rights (e.g. access to the policy's cash value or the surrender of the policy) except for beneficiary designation requires the signature of both the executive and the employer. A restricted access schedule can be utilized as part of the written restricted executive bonus agreement that is prepared by the employer's legal advisor to give the executive incremental access to the policy's cash value.
- 4 POLICY DISTRIBUTIONS** Once the executive acquires access or the direction form is removed from the policy, the executive may access the available cash value of the life insurance policy through loans and withdrawals for emergencies or other financial needs.¹⁴
- 5 DEATH BENEFIT** At the executive's death, the life insurance death benefit proceeds will be paid to the executive's beneficiaries income tax-free.¹⁵

¹³ The deductibility of the bonus is subject to the reasonable compensation limits established by IRC Sec. 162(a).

¹⁴ Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

¹⁵ For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

In a restricted executive bonus design, the restricted portion of the policy does not revert back to the employer if the executive leaves prior to acquiring access. How may the employer retain more control and protection for the business?

How a forfeitable restricted executive bonus arrangement (FREBA) works

A forfeitable restricted executive bonus arrangement works similarly to a restricted executive bonus arrangement except that there is an additional component. The business and the executive enter into an employment agreement that is prepared by the employer's legal advisor which states that if the executive leaves the business prior to a specified date, the executive may have to repay the business a portion of or all of the bonuses.¹⁶

A forfeitable restricted executive bonus arrangement provides many of the benefits of more conservative bonus designs along with the added benefits of a possible return of bonus payments to the employer. These added benefits, however, make it essential that business owner clients consult their attorneys before implementing it.

ERISA and TAX ISSUES

How is a forfeitable restricted executive bonus arrangement treated under ERISA?

- Because a forfeitable restricted executive bonus arrangement requires repayment of bonuses upon a premature departure by the executive, the arrangement may be considered a retirement plan under ERISA.¹⁷

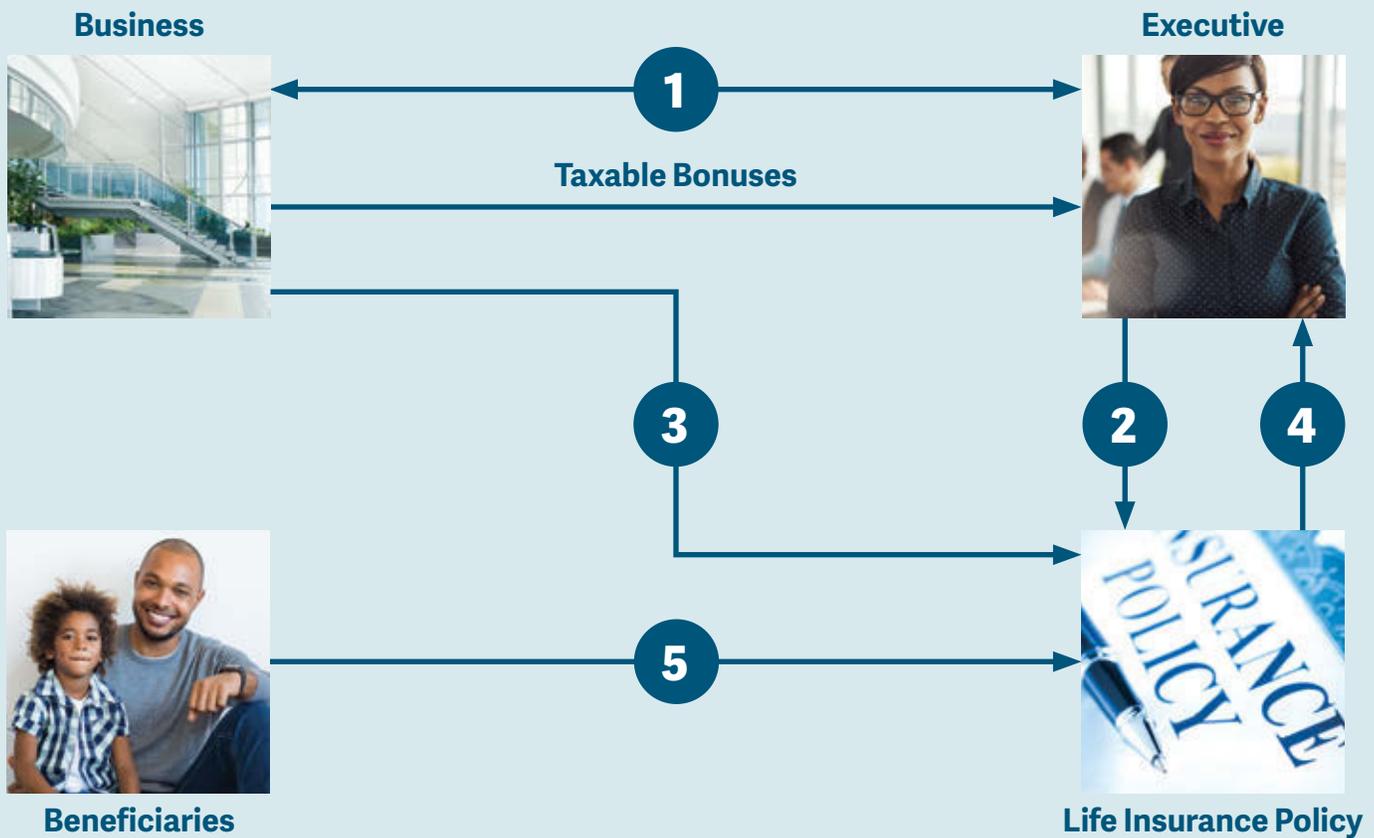
How does the tax deduction in a forfeitable restricted executive bonus arrangement work?

- The employment agreement requiring the executive to repay the bonuses upon a premature departure may jeopardize the business's ability to take a current tax deduction for the bonus payments.



¹⁶ Please note that the repayment of the bonus may be considered taxable income to the business. In addition, the executive may not have a corresponding tax deduction or tax credit for the repayment of the bonuses (See IRC Sec. 162).

¹⁷ Please consult with your employee benefits legal counsel as to whether this is an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) and if so, whether any additional requirements are necessary to comply with ERISA.



1 AGREEMENTS

The employer enters into a written agreement (prepared by the employer’s legal advisor) with the executive to assist with the purchase of a life insurance policy through a series of taxable bonuses. The agreement will contain a restricted access schedule which will preclude the executive from accessing the policy’s cash value until a specified date. In addition, the business will enter into an employment agreement (prepared by the employer’s legal advisor) with the executive. The employment agreement may require the executive to repay the bonuses to the business if the executive does not stay with the business for a specified period of years.¹⁸

2 PREMIUM PAYMENTS

The executive uses the bonuses to purchase a personally-owned life insurance policy. The executive names the beneficiary of the policy’s death benefit.

3 DIRECTION FORM

A restricted executive bonus direction form is filed with the life insurance company that issued the policy. The direction form states that the exercise of any policy ownership rights (e.g. access to the policy’s cash value or the surrender of the policy) except for beneficiary designation requires the signature of both the executive and the business. A vesting schedule can be utilized in the employment agreement to give the executive incremental access to the policy’s cash value.

4 POLICY DISTRIBUTIONS

Once the executive meets the requirements of the agreements or, the direction form is removed from the policy, the executive may access the available cash value of the life insurance policy through loans and withdrawals for emergencies or other financial needs.¹⁹

5 DEATH BENEFIT

At the executive’s death, the life insurance death benefit proceeds may be paid to the executive’s named beneficiary income tax-free.²⁰

¹⁸ Please note that the repayment of the bonus may be considered taxable income to the business. In addition, the executive may not have a corresponding tax deduction or tax credit for the repayment of the bonuses (See IRC Sec. 162).

¹⁹ Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

²⁰ For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the “transfer-for-value rule”); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

Things you need to know...

Income taxation of the executive's bonus

How may the executive's bonus be designed?

The bonus can be designed as either a "single" or "double" bonus. The single bonus does not include employer reimbursement of any income tax that is payable by the executive. The double bonus "grosses up" the single bonus to include an additional amount that is intended to cover the income tax due on the single bonus. The example below depicts the differences between a single and double bonus plan for a \$10,000 bonus.

	Single Bonus	Double Bonus
Bonus Amount	\$10,000	\$16,666
(less taxes*)	\$4,000	\$6,666
Net Bonus	\$6,000	\$10,000

** Assumes a 40% combined federal and state income tax bracket.*

With the single bonus, the executive will receive a \$10,000 bonus but will have only \$6,000 after payment of income taxes. The double bonus nets the executive the full \$10,000 but at a significantly higher cost to the employer. The formula for calculating the double bonus is: desired contribution / (1 – executive's tax bracket). When combined with the tax advantages of a properly structured life insurance policy, the double bonus design gives the executive a tax-favored method of accumulating cash value for emergencies or other financial needs.



Income-tax deduction may not exceed reasonable compensation

What is considered reasonable compensation?

- Whether total compensation, including bonuses, constitutes reasonable compensation is based on the facts and circumstances of the case. Some of the factors used in determining reasonable compensation are:
 - Services performed;
 - Volume and complexity of the business;
 - Prevailing general economic conditions;
 - Individual ability of the employee;
 - Previous technical training and experience;
 - Profitability to company of executive's services;
 - Corporation's dividend policies and history;
 - Compensation in prior years; and
 - Corporate earnings.

If total compensation is deemed unreasonable, is payment partially deductible?

- The amount in excess of what is reasonable would not be deductible by the employer.²¹
- In most instances, issues of unreasonable compensation surface in closely held businesses where there could be an attempt to disguise non-deductible dividend payments as deductible compensation.

Is there a maximum tax deduction of an executive's bonus?

- In a publicly held company, compensation for certain highly paid officers in excess of \$1,000,000 is not deductible.²²

²¹ Treas. Reg. Sec. 1.162-8.

²² IRC Sec. 162(m)(1).



ERISA compliance

Does an executive bonus arrangement require the employer to comply with ERISA?

- Whether ERISA applies, and what degree of compliance is required, hinges on the bonus design. If the bonus is structured as a cash bonus (i.e., the executive has the choice between taking the bonus in cash or having it paid into the insurance policy), compliance may not be required since cash bonuses are generally not covered under ERISA.²³
- If the employer is making premium payments directly to the insurer, the bonus is more likely to be considered part of a welfare benefit plan.
- Welfare benefit plans are required to comply with Parts 1, 4, & 5 of Title I of ERISA. This usually entails reporting and disclosure (Part 1), fiduciary responsibility (Part 4), and claims procedures (Part 5).

To what extent does an executive bonus require ERISA compliance?

- The extent of compliance under Title I depends on the executives covered under the plan. If the bonus is noncontributory and is limited to a select group of management or highly compensated executives (called the “top hat” group), the only ERISA reporting requirements for Part 1 are a single page letter to the Department of Labor stating that the top hat plan is in place, and to make plan documents available to the Department of Labor at their request.²⁴
- For plans of less than 100 executives, a summary plan description is needed.²⁵ Plans covering 100 or more executives require full Part 1 compliance, which includes Form 5500 reporting, summary annual reports, and a summary plan description. All forms of welfare plans must comply with the fiduciary and claims procedure requirements of Parts 4 & 5 of Title I.

²³ 29 C.F.R. Sec. 2510.3-2(c).

²⁴ 29 C.F.R. Sec. 2520.104-24(a)(1).

²⁵ 29 C.F.R. Sec. 2520.104-20.

Life insurance is subject to underwriting and approval of the application and will incur monthly policy charges.



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