PACIFIC LIFE

**ADVANCED SALES SOLUTIONS AT-A-GLANCE**

# EXECUTIVE BONUS PLAN

### How to Use Life Insurance to Reward Key Executives

A significant portion of a successful business operation relies on the unique skills and expertise of key executives. Your business owner clients may be looking for a way to reward these top performers to help ensure they continue to work for them and not leave to join a competitor's business. An executive bonus plan using life insurance[1] can be an effective way to achieve that goal.

## What is an Executive Bonus Plan?

An executive bonus plan (a.k.a Section 162 plan) can be used to attract, retain, and reward key talent. It combines life insurance and strategic compensation via bonuses to the key executive to benefit both the business and the key talent.

### Potential Benefits

**For the Business**

- Bonuses paid to the key executive are tax deductible.[2]
- Since bonuses are taxable to the key executive, the business may want to gross up or double the bonus amount, which is also tax deductible to the business.[2]
- The business has the flexibility to choose which key executives will be covered, the amount of the bonus, and the terms and conditions.

**For the Executive**

- Typically, the key executive owns the life insurance policy, is the insured, selects the beneficiaries, and retains full ownership rights.[3]
- The key executive's beneficiaries will receive an income tax-free death benefit.[4]
- Cash value life insurance allows the key executive to access any available policy cash value through tax-free withdrawals and loans throughout their lifetime.[5]

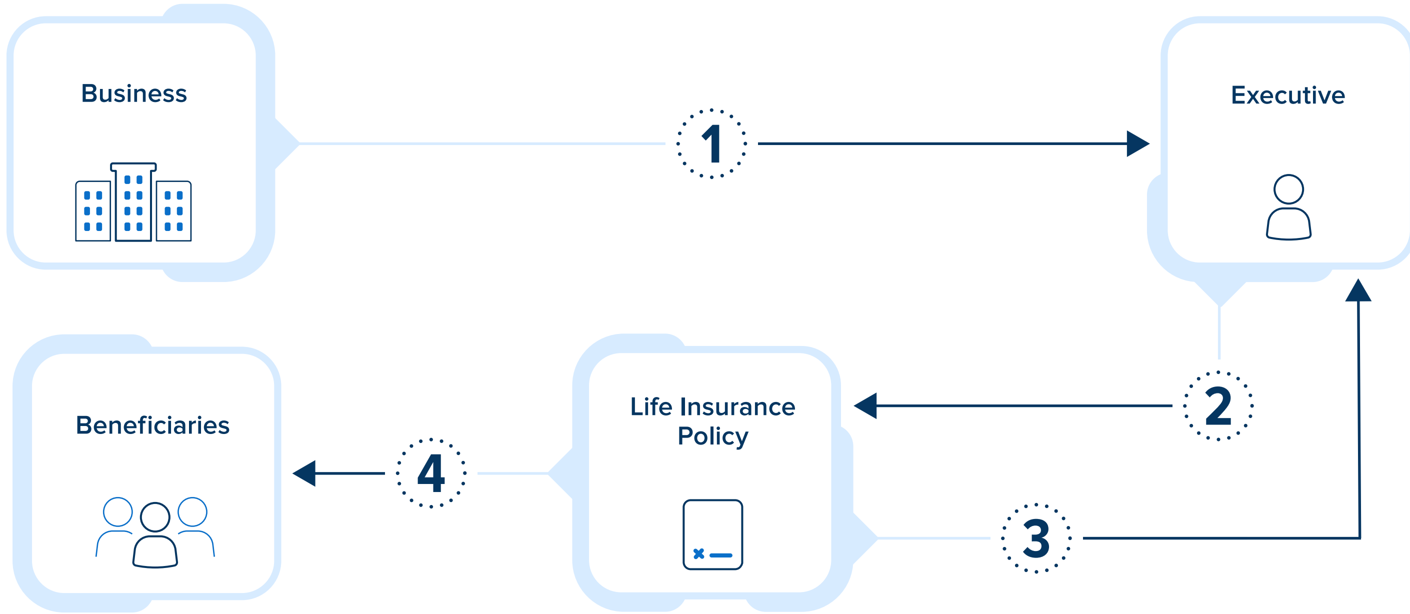
[1]Note that the primary purpose of a life insurance policy is to provide death benefit protection to family members or co-business owners in the event of the insured's premature death.

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

[3]A restrictive executive bonus arrangement, also known as a controlled or golden handcuffs executive bonus arrangement, generally stops the insured executive from accessing the policy cash value without the consent of the employer.

[4]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).

[5]For federal income tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause or occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC Secs. 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.




## How it Works

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| **1** | **Taxable Bonuses** | ▪ Bonuses paid to the key executive are tax deductible.[2]<br>▪ The business agrees to assist the key executive with the purchase of a life insurance policy through a series of taxable bonuses.<br>▪ The bonuses are potentially tax-deductible for the business[2] and may be "grossed-up" to help reimburse the key executive for income taxes generated as a result of the additional compensation. |
| **2** | **Premium Payments** | ▪ The key executive uses the bonuses to purchase a personally owned life insurance policy.<br>▪ The key executive maintains complete ownership of the policy and names the beneficiary of the policy's death benefit. |
| **3** | **Policy Distributions** | The key executive may access the available cash value of the life insurance policy through tax-free[5] loans and withdrawals for emergencies or other financial needs. |
| **4** | **Death Benefit** | At the key executive's death, the life insurance proceeds will be paid to the executive's beneficiaries income tax free.[4] |

## Considerations[6]

- The business generally cannot recapture the bonuses given to the key executive.
- The key executive must recognize the bonus payments as taxable income.
- Unless additional planning is done, the death benefit of the policy will be included in the key executive's estate.
- An executive bonus arrangement may result in no income tax advantages when used to benefit an owner of a pass-through business (e.g., partnership, S-corporation, or Limited Liability Company), and may have adverse payroll tax consequences for owners of S-corporations.

[6]It's essential to seek advice from a tax advisor to ensure the bonus arrangement complies with tax regulations and is financially optimal for both the corporation and the business owner.



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