

Executive Bonus Arrangements

Reward, Recruit and Retain Key Employees
Utilizing IRC 162 and Life Insurance



Offering key employee benefits can help improve employee retention, productivity, loyalty, and can help protect and secure a company's financial future.

Key employees have many needs that an Executive Bonus arrangement can help them with, including:

- Life insurance protection for family
- Supplemental retirement income
- Estate and legacy planning
- Financial emergencies

An Executive Bonus, also known as a Section 162 arrangement, is a non-qualified employee benefit arrangement in which the employer pays all or part of the premiums of a cash value life insurance policy for the key employee as a "bonus". The "bonus" is taxable income to the employee and deductible to the employer to the extent that the bonus is considered "reasonable compensation".^{1,2}

Using an executive bonus arrangement, the employer is able to provide an attractive benefit to the employee to recruit, reward and/or retain that key employee.

Concept overview:

The key employee is the insured* and owner** of the policy.

- The key employee can name whomever they would like to as the policy beneficiary.
- The premiums are paid by the employer via taxable bonuses to the key employee.
- The employer is able to take an income tax deduction for the bonus.¹
- The plan provides the employee with death benefit protection, as well as potential supplemental retirement cash-value growth.³

Potential candidate:

- Employers who want to recruit, reward and/or retain key employees
- Employers who would like to provide key employees non-qualified benefits with less cost, administration and complexity of non-qualified deferred compensation plans or qualified plans

- Employers looking to establish an arrangement for non-owner key employees of pass-through entities (S-corporations, partnerships, and LLCs)
- Employers looking to establish an arrangement for owners or non-owner key employees of a C-corporation

Advantages & considerations:

For the employer –

- Flexibility to customize plan
- Up-front income tax deduction¹
- Ability to restrict access to cash values (see section on REBA)
- Ability to select which key employees to provide the arrangement, as there are no minimum participation or top-hat requirements
- Less cost, complexity and administration than qualified plans or non-qualified deferred compensation plans

For the employee –

- Ownership of the policy and ability to choose beneficiary
- Income Tax-free*** death benefit protection for family
- Potential for tax-deferred growth of values
- Helps fill the retirement income gap
- Potential income tax-free access to cash value for emergencies and supplemental retirement income³
- Bonus is taxable as income to the employee

"Double bonus"

If the employer wishes to minimize the income tax impact to the employee due to the taxable bonuses, the employer may choose to do a "double bonus" and bonus an additional amount to the employee to account for the income tax that will be due on the bonus.

Steps:

1 Taxable bonuses

Employer agrees to provide a series of taxable bonuses to the key employee for the purchase of a life insurance policy. The bonuses are potentially tax-deductible for the employer and may be “doubled” to help reimburse the key employee for income taxes generated as a result of the bonuses.

2 Premium payments

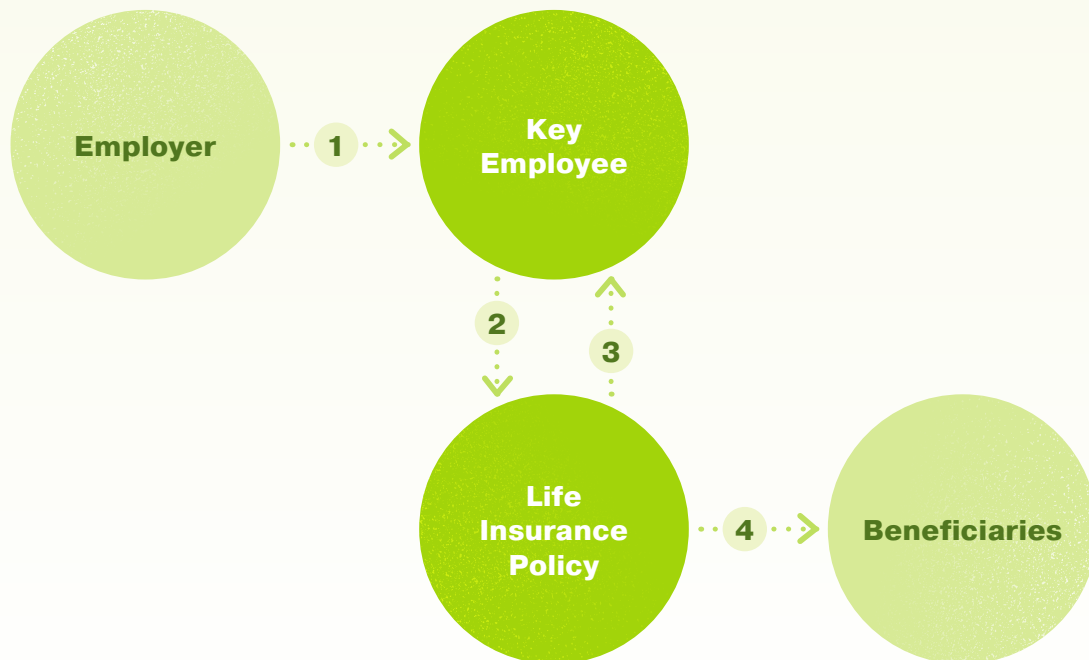
The key employee uses the bonuses to purchase and pay the premiums on a personally-owned life insurance policy [note: the employer could also pay the premiums directly as the Payor on the policy]. The key employee names the policy beneficiary(ies).

3 Access to policy cash value

The executive may access the policy cash value through loans and/or withdrawals for supplemental income or other financial needs. If arrangement is a REBA, the key employee would need to meet the terms of the REBA agreement and the employer would have to provide their signature to grant the key employee access to the cash value.

4 Policy death benefit proceeds

At the key employee’s death, the life insurance proceeds will be paid to the key executive’s designated beneficiary(ies).



*Insured could also be the spouse of the employee, or both key employee and spouse could be joint insureds

** Owner could also be a trust established by the insured

*** 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).

¹IRC Sec. 162; ²Treas. Reg. Sec. 1.162-8; ³Accessing cash value will reduce the death benefit, may result in fees, and may require additional premium to keep the policy in-force.

Variations of Executive Bonus Arrangements:

Restricted Executive Bonus Arrangement (REBA)

With a traditional executive bonus arrangement, the key employee is incentivized to stay with the company while the policy is still in the premium paying stage, as the bonuses from the employer are being used to pay the premiums. However, if an employer is looking to further incentivize the employee to stay, a Restricted Executive Bonus Arrangement (REBA), may be a good option.

A REBA is similar to a traditional executive bonus arrangement, except that there is an extra element to it – the employer's ability to restrict the key employee's access to the cash value within their own policy according to the terms of a REBA agreement that is entered into between the employer and key employee.

For this variation of the arrangement, two additional documents will be necessary – the aforementioned REBA agreement and the carrier's direction form for a REBA.

The REBA agreement between the employer and key employee outlines the terms of the arrangement and typically provides an "access schedule" outlining when the employee will be given access to the cash value, as well as the terms for the termination of the restriction altogether. Generally, the access schedule will provide that the restriction remain in place for a specified number of years or until a specified date.

It is important to note that if the key employee were to terminate employment prior to satisfying the terms of the agreement to remove the restriction, the key employee may never have access to the cash value within their own policy. However, their designated policy beneficiary would still be entitled to the entire death benefit. Additionally, since the employer holds no interest in the actual policy, there would never be any cost recovery to the company.

Split-Premium Bonus Arrangement

For an employer that would like to provide their key employee with the benefit of a life insurance policy, but is not looking to provide a large enough bonus to cover the entire premium amount, a split-premium bonus arrangement may be appropriate. For this variation of the arrangement, the employer still provides a taxable bonus to the key employee, however it is just for a portion of the premium and the key employee pays the remainder of the premium (typically paid via payroll deduction).

While the employer can choose to bonus as large of a portion of the premiums as they would like, since cash value life insurance policies have charges associated with them, oftentimes the employer's portion provided for the premium is equal to the life insurance policy charges – this could be an increasing amount over time or it could be a level premium amount.

This allows the employer to still provide an attractive benefit to the key employee by assisting with a portion of the premium payments and making the policy more affordable, without providing for the cost of the full premium amount.

Important Information for Illustration



Proposed Insured/Key Employee's Vital Information

Name:

Date of birth:

Tax bracket:

State of issue:

Underwriting classification:

Employer's Vital Information

Name:

Tax bracket:

Premium requirement:

Desired amount paid by employer:

"Double bonus"?

Premium payment period:

Death benefit:

Goal – max cash or max DB:

Illustrate distributions? If so, what years?

Business domicile:

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