Design options and key employee income tax consequences

Bonus plans can help recruit, reward, and retain key employees. Under a typical Bonus plan, the employer pays a bonus to a key employee. The key employee then asks the employer to use part of that bonus to pay premiums on a life insurance policy which insures (and is owned by) the key employee. The premium amount, along with any other bonus compensation paid to the key employee each year, is generally taxed as reportable bonus income (e.g., W-2 income) to the key employee and may be deductible for the business (provided the bonus amounts represent reasonable compensation). If cash value life insurance is used, in addition to providing death benefit protection, life insurance policy values may be available to supplement the key employee's future cash flow needs, such as funding a child's education or supplementing retirement income.

Bonus design options

In terms of defining how much the employer contributes to the plan, here are the two most popular (and simple) bonus designs:

Single Bonus

With a "single bonus" design, the employer pays the premium amount and the key employee pays tax on the amount of the bonused premium amount.

- **Q:** Why must the key employee pay tax on the cash bonus in the year when the employer submits the premium payment directly to Principal®?

- **A:** The employer is submitting cash to pay a premium on the key employee's behalf. Since the premium payment is applied to the key employee's personally owned policy, the Internal Revenue Service (IRS) considers the key employee to be in "constructive receipt" of the amount paid and must therefore recognize the amount of the bonused premium as reportable/taxable income.

  Example explanation - When the employer submits premium on the key employee's behalf, the IRS considers it equivalent to a two-step process whereby (1) the employer pays extra bonus income to the key employee through the payroll process, and (2) the key employee submits the premium payment to Principal. With this two-step process it's readily apparent the extra bonus income is taxable. Thus, the IRS requires similar tax treatment when the employer submits premium payments directly.)

Double Bonus

With a "double bonus" design, the employer both pays the premium (which as described above represents taxable bonus income) and "grosses up" the bonus (i.e., provides an additional cash bonus to the key employee) to help cover the tax that will result from the total bonus. This total bonus – the cash bonus in the amount of the premium bonus *plus* the additional cash bonus – is referred to as a "double bonus." The key employee pays tax on the double bonus, and from the key employee's perspective, this results in a "zero net outlay for income tax purposes."

Refer to the table below for single bonus and double bonus formulas and examples.

Single Bonus and Double Bonus formulas and examples

	Single Bonus	Double Bonus
Business pays…	Premium amount	Premium amount + additional cash bonus to cover taxes
Formula to determine bonus amount (The bonus amount is reported as W-2 income.)	Bonus = Premium amount	Bonus = $\frac{\text{premium amount}}{(1 – \text{employee income tax rate})}$
Example Assume: • $20,000 premium • 30% key employee income tax rate	**Results:** • Business pays $20,000 premium amount • Bonus (W-2 income) = $20,000 • Key employee must pay tax on total amount of bonus: $20,000 x .30 tax rate = $6,000 tax **Summary:** Key employee has $20,000 premium amount applied to policy and incurs $6,000 tax.	**Results:** • Business pays $20,000 premium amount • Bonus (W-2 income) = $\frac{\$20{,}000}{(1 - .30)}$ = $28,571 The bonus is made up of $20,000 premium bonus + additional cash bonus of $8,571 to cover taxes on total bonus. • Key employee must pay tax on total amount of cash bonus: $28,571 x .30 tax rate = $8,571 tax* *The additional $8,571 cash bonus exactly covers the $8,571 tax. (Another way to view this is to break it down further: Key employee's tax on the premium bonus amount is $6,000 (see **Single Bonus** column at left). With the double bonus approach, the business provides the additional $8,571 cash bonus, which results in $2,571 tax (i.e., $8,571 x .30 tax rate = $2,571 tax), leaving $6,000 (i.e., $8,571 cash bonus - $2,571 tax = $6,000). This remaining $6,000 exactly covers the $6,000 tax on the premium bonus. **Summary:** Key employee has $20,000 premium amount applied to policy, and the additional cash bonus fully covers all related income tax (resulting in a "zero net outlay").

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