

Bonus Plan retention tools

Bonus plans help recruit, reward, and retain key employees. Under a typical Bonus Plan, the business pays the premiums on a life insurance policy that is owned by a key employee (this employee is usually the insured too). The cash bonus in the amount of the premium payments is taxed to the key employee,¹ and is deductible for the business (as long as the bonus amounts represent reasonable compensation).²

The business may also choose to “gross up” the bonus (i.e., provide additional cash to the key employee to help cover the income tax resulting from the total bonus, so the employee has no out-of-pocket expense). The formula for determining how much to pay when doing this is: $\text{Premium Amount} / [1 - \text{Employee's Tax Rate}] = \text{Total Grossed Up Bonus Amount}$. This is often referred to as a “double bonus.”

Owning a life insurance policy is a valuable employee benefit, as it provides income tax-free death proceeds to beneficiaries, and the employee can access policy cash values – often tax-free – to meet future cash flow needs, such as funding a child’s education or supplementing retirement income.

Does the employer have to forego control to obtain a deduction?

Of course, employers like the fact that Bonus Plans generate a *current* deduction for the amount bonused. The potential downside, however, is that the employer generally relinquishes control with a Bonus Plan. The employee can quit the next day and walk away with the policy.

There are ways the employer can have *some* control (keeping the employee tied to the business) but nonetheless enjoy a current deduction. These include restricting the employee’s ability to access the policy’s cash value, or having a repayment provision, or a combination of the two.

- **Restrictive Agreement:** One way to retain the employee is to use an agreement that restricts the employee’s ability to access the policy’s cash until the employee has been with the business a certain number of years. Such a restriction does not permit the employer to access the cash value itself or to obtain ownership of the policy if the employee leaves “early.” It is just that the employer holds what is essentially a veto power over the employee’s ability to access cash values during the restriction period.

At Principal, this feature is put into effect using a one-page form titled “Request and Agreement to Restrict Owner’s Rights” (Form BB6217) that is added on the policy. For a specified period, it restricts the key employee/policyowner from doing any of the following without the employer’s consent:

- cancelling the policy,
- accessing policy values,
- assigning the policy as collateral, and/or
- changing policy ownership.

Pursuant to the Restrictive Agreement, the employer has the option to keep the restriction in force or specify that it be released in a certain number of years.

- **Supplemental Repayment Agreement:** Another way to help tie the employee to the business is to require the employee to repay some or all bonuses if employment terminates before a certain amount of time passes.

A sample Supplemental Repayment Agreement (also referred to as a Repayment Obligation) is available from Principal, included with its sample Bonus Plan agreement (BB10441). This form offers sample repayment schedule options if the employee quits or is fired for cause. As with any legal document, the

decision of whether to include a repayment provision (one of our samples, or other language drafted by the client's attorney) will be the decision of the employer and the attorney, based on the employer's goals.

Some attorneys might fear that having a repayment provision will cause the premium payment to be treated as a non-deductible (and non-income taxable) *loan* rather than as a bonus. But some case law suggests otherwise.

- For example, in *Winter v. Comm'r*, TC Memo 2010-287, the court held that a bonus that had to be repaid if the employee left before working for a certain number of years was taxable in the year received, rather than taxed in the later year when the employment period would have been met. Ruling similarly was *McCormack v. Comm'r*, TC Memo 1987-11. The conclusion that it wasn't a loan was aided by the fact that the employer did not charge interest and there was no obligation to repay if the employee stayed employed.
- Then again, in *Winter*, the employee had the unfettered right to use the cash bonus in any way he wanted before repayment. It's not clear if this element is always necessary, and if it is, whether a life insurance bonus plan would satisfy this element (offering the employee a premium payment or cash might be more likely to meet it).

As always, of course, whether to use a repayment provision is a decision for each employer to make in discussion with their own legal counsel.

Life insurance is a valuable asset for any individual to own. A policy's cash value grows tax-deferred and can be accessed tax-free to meet multiple needs, and of course it can provide a tax-free death benefit to the insured's loved ones. Employers who want to keep their best employees happy might consider establishing a life insurance Bonus Plan, and if they want to add some extra "glue on the employee's seat," the employer might want to add a restriction on the policy or consider a payback provision.

¹ Taxation generally falls under IRC Section 61.

² The deduction falls under IRC Section 162(a)(1) (salaries or other compensation as an ordinary and necessary business expense).



principal.com

Insurance products issued by Principal National Life Insurance Company (except in NY) and Principal Life Insurance Company[®]. Plan administrative services offered by Principal Life. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities offered through Principal Securities, Inc., Member SIPC and/or independent broker/dealers. Referenced companies are members of the Principal Financial Group[®], Des Moines, IA 50392.

The subject matter in this communication is educational only and provided with the understanding that Principal[®] is not rendering legal, accounting, investment, or tax advice. You should consult with appropriate counsel, financial professionals, and other advisors on all matters pertaining to legal, tax, investment, or accounting obligations and requirements.

No part of this presentation may be reproduced or used in any form or by any means, electronic or mechanical, including photocopying or recording, or by any information storage and retrieval system, without prior written permission from the Principal Financial Group[®].

Principal[®], Principal Financial Group[®] and the Principal logo design are registered trademarks of Principal Financial Services, Inc., a Principal Financial Group company, in the United States and are trademarks and service marks of Principal Financial Services, Inc., in various countries around the world.