The Deferral Alternative Bonus Plan

A Good Fit in a Tough Economy?
While the need to retain and reward key employees remains strong, a truly effective executive benefit is sometimes elusive. Although an ideal solution remains largely unavailable, many professionals agree that the solution can be reached after considering a combination of factors. Increasingly stringent legislative oversight has increased the cost and complexity of formal executive bonus and deferral plans, while employees have migrated toward arrangements offering more personal control and flexibility.

Since contribution limitations preclude ordinary qualified plans from effectively covering highly compensated employees, a selective benefit tailored just for key employees has become more and more important. Similar to finding a shoe that's a good fit, it's difficult to match the desires of the employer with the goals and ambitions of a high achieving executive. Many practitioners agree a simple, yet effective executive benefit will be an ideal match even in the toughest economy. In the right situations, the Deferral Alternative Bonus Plan may be that perfect fit.

The Ideal Clients
This strategy is not "one size fits all". Both the employer and the employee must be the right fit. The ideal client for this strategy is an executive with discretionary income who has maxed out his or her 401(k) contributions and is interested in deferring compensation in an effort to reduce current income taxes. These executives may also be concerned about the future ability of the company to meet a promised obligation and would like control over the timing and taxation of their eventual distributions.

The employer, for their part, is seeking a valuable executive benefit without the full cost and complexity of an ordinary executive bonus plan or deferred compensation plan. They find an immediate income tax deduction an attractive benefit to providing the key employee with a bonus.

Let's describe in more detail how the Deferral Alternative Bonus Plan may be the right fit for such discriminating clients.

Please note:
This document is designed to provide introductory information on the subject matter. MetLife does not provide tax and legal advice. Clients should consult their attorney and/or tax advisor before making financial investment or planning decisions.
The Mechanics

The mechanics are fairly straightforward and combine some elements of a typical life insurance executive bonus design and deferred compensation plan. With the **Deferral Alternative Bonus Plan**, the employee receives salary that would have been otherwise deferred. The executive then makes payments directly to a personally owned cash value life insurance policy. The employer for their part, effectively agrees to pay the tax on the amount the employee contributes to the policy by increasing the amount of the bonus accordingly. It is important to emphasize that unlike an IRC §162 Executive Bonus, the premium paid into the policy in a Deferral Alternative Bonus Plan represents money the employee would have received without the employer providing an additional executive bonus. Presumably that is the same amount that the employee would have elected to defer under a traditional salary deferral plan. However, as a result of the additional bonus for taxes, this technique represents a cash flow equivalent of a traditional salary deferral plan without many of the common drawbacks of this arrangement.

Using a properly structured and designed cash value life insurance policy, the executive may accumulate supplemental retirement income in a tax favored manner, as well as provide death benefit for family survivor needs.

Consider the following case study.

Acme Inc. seeks a simple, cost effective way to retain and reward its key employee, Karen Delgado. They are both in a 33% tax bracket and although Karen earns $300,000 per year, the maximum deferral under her 401(k) is $17,500. This falls far short of her $30,000 deferral goal which would represent 10% of income. Karen is loyal to Acme Inc., but has general concerns regarding the future viability of the company and wishes to take control of her own financial destiny. Karen is also concerned that her income tax bracket may be higher in the future. Karen and Acme consider a traditional salary deferral plan, but find the added complexity, cost and tax treatment unattractive.

Instead, they decide on a **Deferral Alternative Bonus Plan** under which Acme agrees to bonus Karen an amount sufficient to cover the taxes on the amount she pays in premium (the amount she presumably would have deferred under a traditional deferred compensation arrangement). Under this arrangement, Karen, targets $12,500 of her own money into a personally owned cash value life insurance policy. Karen is currently in excellent health so her premiums are able to purchase a significant death benefit guaranteed by the financial strength of the issuing insurance company. She also likes that in the event she dies prematurely the full value of the death benefit will be paid to her beneficiaries. Acme bonuses the tax cost to Karen through a deductible payment of $6,157.

This puts Karen in essentially the same financial position as a salary deferral where she has no out-of-pocket costs other than the salary she would have deferred. On the other hand, the net cost to Acme is $4,125. Again, the only bonus cost to the company is the actual or anticipated tax on Karen’s contribution. (The benefit of this concept is that Acme doesn’t have to pay the full premium just the amount of the taxes). Should Acme wish to place handcuffs on future bonuses to Karen, they may wish to establish those conditions within the terms of the original agreement.

The contrast between a conventional deferral plan and an alternative bonus plan is striking. In the scenario outlined above, the employee maintains current ownership and from an “out of pocket” perspective is in the same financial position as a deferral arrangement. The net bonus cost to the company is similar to a traditional salary deferral plan. The key difference however, is that unlike a deferred compensation plan, the employee owns her own executive benefit in the form of a life insurance policy and if structured properly, future distributions taken via policy loans and withdrawals can be tax-favored.

Contact us today for the most up-to-date information.

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1 Subject to reasonable compensation rules.
2 $12,500 is the difference between Karen’s $30,000 goal and the $17,500 currently set aside in her 401(k) through Acme Inc.
3 To calculate the amount of bonus needed to cover the taxes, you need to determine how much Karen needs to receive in income to result in a net of $12,500. ($12,500/1-taxon rate. $12,500 / .67 = $18,657) Acme needs to increase Karen’s salary by $6,157 so that she nets $12,500 for the premium payment. Exposure to ERISA Guidelines. When ascertaining the eligible group, generally not more than 10% of the total number of employees should be included in the plan.
4 $6,157 (bonus is deductible if considered reasonable compensation) -33%(corporate tax bracket) = $4,125.00
5 Loans and withdrawals will decrease the cash value and death benefit. Tax-free distributions assume that the life insurance policy is properly structured, is not a Modified Endowment Contract (MEC), and distributions are made up to the cost basis and policy loans thereafter. If the policy has not performed as expected and to avoid a policy lapse, distributions may need to be reduced, stopped and/or premium payments may need to be resumed. Should the policy lapse or be surrendered prior to the death of the insured, there may be tax consequences. Cash value accumulation may not be guaranteed. Investments into variable life insurance are subject to market risk including loss of principal.

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