Executive Bonus Plans

Running a successful business often depends on recruiting, rewarding and retaining talented executives and key employees who are committed to the business owner's goals. In addition to paying an attractive salary, the business owner must offer a competitive benefits package. Trouble is, government regulations make it difficult for employers to provide qualified benefits on a "pick-and-choose" basis. Qualified plans, like 401(k) plans, must cover a broad group of fulltime employees, not just the key executives or key employees.

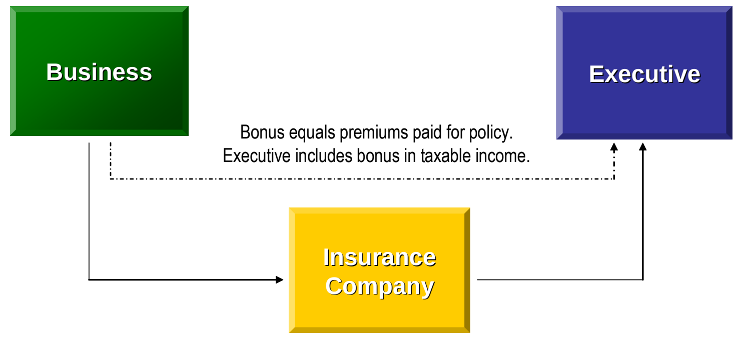
One Solution: An Executive Bonus Plan

Unlike qualified benefits, non-qualified benefits can be designed to cover only key executives and employees. A common non-qualified benefit is the Executive Bonus Plan that provides the business with an immediate income tax deduction.

The employer can simply raise the key executive's salary, so that the executive can purchase his or her own benefits, including life insurance benefits. If the salary increase is reasonable, the employer will be able to take an immediate income tax deduction for the bonus payment. The executive will have to include the salary increase in his or her taxable income, but after paying taxes, the remaining bonus will be available to fund premium payments.

How Does It Work?

The bonus plan is very simple to implement. The employer pays the premium on the life insurance policy, and that premium is reported as additional income to the executive. The executive is only responsible for the income tax due on the additional income. A life insurance policy is issued on the life of the employee, who owns the policy and names personal beneficiaries. The employee has full access to the policy's cash value, and complete freedom to change the beneficiary. Employees like the arrangement because it is portable.



The employer may also choose to make an additional bonus to the executive for the income and payroll taxes that the executive may incur from this bonus. This is known as a double bonus arrangement, resulting in a zero tax outlay by the executive.

Single Bonus Example:

Employer pays $1,000 premium. Executive is in the 28% tax bracket. Executive receives the benefit of the $1,000 premium paid at an out-of-pocket cost of $280 for income taxes.

Double Bonus Example:

Same as above but the employer bonuses an additional amount in income to the executive to pay the income taxes due. The formula to determine the double bonus is the premium paid divided by (1 minus the tax rate). Here, it is $1,000/1-.28 = $1,388.89. The tax due is $388.89. The executive receives the benefit of the $1,000 premium paid at no additional out-of-pocket cost.

Benefits

There are many advantages to an executive bonus plan for both employer and employee.

- The employer has a recruiting and retention tool that is easy to establish, can be done on a selective basis, and can be customized in terms of benefit and contribution for each chosen employee.
- The employee receives a benefit with little out-of-pocket expense (or none, if a double bonus plan is used).
- The employee has access to the policy cash values, and his or her personal beneficiaries will receive an income tax-free death benefit.
- The policy will generally be free from the claims of the employer's creditors, since it is personally owned by the employee.
- The policy is portable if the employee does decide to change employers.
- This technique can also be used with disability income insurance or annuities.

Note

Some advisors believe that the expansive definition of "deferred compensation" in the final 409A regulations can make executive bonus plans subject to the restrictive rules in IRC §409A. However, if the premium bonus is paid as a matter of employer discretion within 2 ½ months after the close of either the employer's or insured's taxable year (i.e., the so-called "short term deferral rule"), some advisors believe that executive bonus plans will not be subject to IRC §409A.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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The Guardian Life Insurance Company of America, 7 Hanover Square, New York, NY 10004