Strategy Snapshot: Executive Benefit Planning

Leveraged Bonus: Income Tax Deduction Plus Control

Case Scenario

Meet Michele. She is the owner of a small but thriving awning manufacturing company, Canopy, Inc. (Canopy), which employs 20 full-time people. She realizes that the success of the business is due to two key employees — David and Ernie. Michele doesn't want these employees to leave and go work for the competition, so she is looking for a strategy that will entice them to stay at Canopy. She is hesitant to just pay them a higher salary or to give them a cash bonus because, although she likes the income tax deduction for Canopy, she knows that as soon as she pays them, she will lose control, and they may spend the money.

Both David and Ernie have families, and Michele wants to help these key employees save for retirement and protect their families if one of them should die prematurely. Additionally, Michele wants to retain some element of control over whatever strategy she chooses. So, she is looking for an approach that will get an income tax deduction for Canopy but also allow it to maintain some control over any money spent on the strategy.

Any examples provided are hypothetical and for illustrative purposes only. Examples include fictitious names and do not represent any particular person or entity.

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Goals

- Entice David and Ernie to stay at Canopy.
- Provide a death benefit for their families.
- Supplement their retirement income.
- A current income tax deduction for Canopy.
- Maintain control over any strategy that is put in place.

Leveraged bonus arrangements provide incentives for employees while providing employers an income tax deduction and helping them maintain some control.

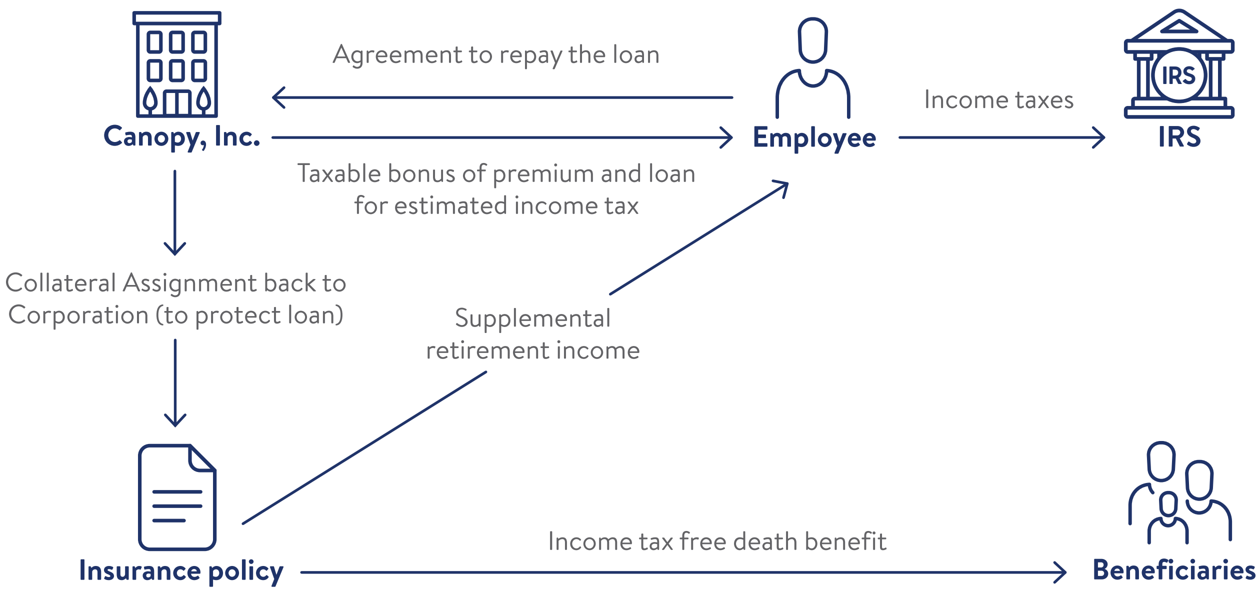
A Possible Solution

Michele contacted her financial professional, who suggested an executive bonus arrangement. This arrangement provides that David and Ernie purchase personally-owned policies on their lives and name the beneficiaries. Canopy pays David and Ernie annual bonuses equal to the premiums. The bonuses are tax-deductible to Canopy and currently taxable to David and Ernie. Under an executive bonus arrangement, David and Ernie will also own any potential policy cash value and be able to access[1] the cash value at retirement through loans and withdrawals. However, they can also surrender the policy at any time, which conflicts with Canopy's interest in having some control over any strategy that is put into place — in this instance, the cash value.

[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty.

Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

That is where a leveraged bonus arrangement can help. It is set up the same way as an executive bonus arrangement except that instead of David and Ernie paying the income tax on the bonuses, Canopy agrees to lend to David and Ernie the amount of income tax on the premium bonuses. Interest is paid on the loan based on a rate equal to or greater than the appropriate applicable federal rate. The loan is secured by a collateral assignment of the policy cash values. This provides the control that Canopy wants. It will prevent David and Ernie from accessing[1] the cash value through loans and withdrawals without permission from Canopy. Additionally, if either David or Ernie does end up leaving Canopy and doesn't voluntarily repay the loan, Canopy can contact MassMutual and request repayment of the loan from the cash value of the policy. If David or Ernie dies, the loan is first re-paid from the death benefit, with the balance going to the named beneficiaries.



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