

Executive bonus arrangements

Foreword to counsel and specimen documents

Introduction	2
Structure	2
Tax consequences	3
ERISA considerations	4
Other considerations	7
Specimen Resolution Approving Executive Bonus Arrangement	9
Specimen Executive Bonus Arrangement	10



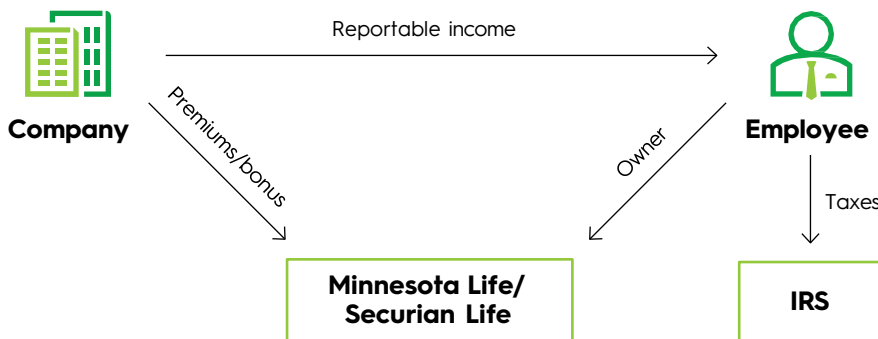
Introduction

An executive bonus arrangement provides a benefit to an employer’s most-valued employees. The benefit provides the employee with the funds to purchase a personal life insurance policy. The life insurance policy provides a death benefit for the employee’s family if the employee dies while owning the life insurance. At retirement, the employee may withdraw the cash values from the life insurance.

As a general guide, the employee is not an owner of the business. However, there are exceptions to this general guideline. Minority owners, who are also key employees, may be candidates for the executive bonus arrangement.

Structure

The employee applies for a life insurance policy and designates the beneficiary. The employee is the owner of the life insurance policy and typically the insured. The employer pays the policy premiums directly to the insurance company and the amount of the premium payment is included in the employee’s income.



Tax consequences

Income taxes – employee

Premium payments are treated as compensation to the employee and are subject to income taxation. The premium payments should be reported on the employee's W-2 form.

Generally, taxation to the employee is governed by Internal Revenue Code (IRC) Section 61, which includes as gross income all income from whatever source, including compensation for services, fees, commissions, fringe benefits and similar items. The regulations under Section 61 state: "Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee."¹

Note this regulation includes "life insurance premiums" as income of the employee in contrast with the "cost of life insurance protection" as used in other parts of the regulations.² This implies the entire premium – not just the economic benefit costs – is currently taxable to the employee, because the employee owns the life insurance contract and the employer pays money on behalf of the employee to purchase or continue that contract. The regulation distinguishes this situation from life insurance on the employee's life "which is carried directly or indirectly by his employer."³ It is only when the insurance is carried by the employer that it is just the "cost of life insurance protection" and not the entire premium taxable to the employee.

Discussion of the tax consequences to the employee is not complete without an analysis of the effect of IRC Section 83 on the executive bonus arrangement. Section 83 applies when "property" is transferred in connection with the performance of services. Regulations state that the term "property" does not include money.⁴ In an executive bonus arrangement, the employer pays money to an insurance company on behalf of the employee. The money is used to purchase or continue a policy that is owned by the employee. The employer at no time owns the policy, and, thus cannot transfer the property. Consequently, Section 83 does not apply to this type of transaction.

Section 83 generally applies only to an arrangement whereby a cash value life insurance policy is owned by the employer. In an executive bonus arrangement, the insurance is owned by the individual employee. As a result, Section 61 controls and the entire premiums are taxable to the employee when paid. The ultimate income taxation will be the same or similar under both IRC Section 61 and IRC Section 83.

Policy dividends are received income tax free by the employee up to his or her basis, regardless of the dividend option he or she chooses.⁵ Interest earned on dividend accumulations, however, is taxed to the employee.⁶

At the employee's death, the insurance proceeds are paid out income tax free.⁷ If the employee surrenders the policy, the cash surrender value in excess of the cost of the contract is taxable as ordinary income to the employee.⁸

Income taxes – employer

The employer is allowed an income-tax deduction under IRC Section 162(a)(1) for the full amount of the bonus in each year a bonus is paid. The premium payment is deductible as compensation to the employee provided (1) the employer is not directly or indirectly a beneficiary under the policy and (2) the premiums constitute additional reasonable compensation for services rendered by the employee.⁹

To ensure the employer will be entitled to the income-tax deduction, the arrangement must also avoid the application of IRC Section 264(a), which would disallow the deduction if the employer is directly or indirectly a beneficiary under the insurance policy. Therefore, the employer must not be entitled to receive any cash values from the policy, nor any portion of the death benefit. The insurance policy is used merely as an incentive for the employee to satisfy the separate employment agreement.

Social Security taxes

The premium payments are subject to Social Security taxes. The full amount of the premium payment will be subject to Social Security taxes, if the employee's salary is below the Social Security taxable wage base.

ERISA considerations

Plan requirement

The potential impact of the Employee Retirement Income Security Act of 1974 (ERISA)¹⁰ should be considered when designing any form of employee benefit. ERISA can impose burdensome participation, reporting and disclosure requirements. An executive bonus arrangement should be able to avoid these ERISA requirements because the existence of a "plan" is a prerequisite to jurisdiction under ERISA.¹¹ ERISA applies only to "an employee welfare benefit plan or an employee pension benefit plan or a plan which is both."¹²

For example, a U.S. District Court in Kansas provided important guidance in *Lackey v. Whitehall Corporation*,¹³ where it stated employee benefits "provided in a contract negotiated by an employer and an individual employee is not an employee benefit plan for the purposes of ERISA."¹⁴

In determining whether there is a plan, the courts consider all the facts and circumstances surrounding the arrangement.¹⁵ In *Lackey*, the facts and circumstances that were considered important were that the plan was not treated as a general plan for the entire management team, there were no plan documents, no funding accounts, no named fiduciaries or trustees, and no assets held in trust as with typical employee benefit plans. Consequently, under these guidelines, an individually negotiated executive bonus arrangement should not be considered an ERISA plan and will not be subject to any of the ERISA reporting or vesting requirements.

The conclusion that the executive bonus arrangement falls beyond the reach of ERISA is supported by the 5th Circuit Court of Appeals in *Murphy v. Inexco Oil Company*.¹⁶ In the court's analysis, it observed that Congress did not intend to "control every aspect of the employer-employee relationship or every promise made to employees."¹⁷ Instead it sought only to deal with those types of abusive plans and practices it sought to remedy.¹⁸ The court noted ERISA was intended to be applied only to those plans that permit the employer to take action inconsistent with the employee's anticipated retirement benefits.

The executive bonus arrangement design prevents the employer from taking action inconsistent with the employee's anticipated benefits. In fact, the employer has no rights in the policy and, therefore, cannot access any of the cash value or act in any way against the employee's interest. Accordingly, the executive bonus arrangement is outside the scope of ERISA.

In designing a particular executive bonus arrangement, the above reasoning should be kept in mind if the intent is to avoid a plan that is covered by ERISA. This means an executive bonus arrangement should only be considered on an individual basis when negotiating the employee's employment contract. It should not be drafted as part of a plan or set up in such a way that any employee meeting certain requirements is entitled to have this arrangement included in his or her compensation package. When the arrangement is being considered for a particular employee, the specific terms and potential forfeiture provisions should be subject to negotiation.

Top hat exemption

If the facts and circumstances discussed above are in question, the executive bonus arrangement may still avoid ERISA's burdensome participation, reporting and disclosure requirements by falling under the top hat exemption. If the executive bonus arrangement was considered a plan for ERISA purposes, it would have to be characterized as a pension benefit plan, a welfare benefit plan or a plan that is both. The top hat exemption may apply to both the pension benefit and welfare benefit plans. The top hat exemption applies to plans providing benefits for a select group of management or highly compensated employees.

The important requirement under the top hat exemption is the "management or highly compensated" concept. Executives in a top hat group must qualify as "management or highly compensated" employees. These employees are typically management who impact the profitability of the company or are employees who are usually in the highest paid levels of the company.

Rank and file employees cannot be included in the top hat group. Rank and file employees generally provide support services, are not highly compensated, do not influence the direction or management of the business or cannot influence the design of the plan.¹⁹

Management

If the executive is clearly management, then the executive would be able to meet the “management” requirement. However, ERISA offers no definition of “management.” Therefore, the facts and circumstances of the client’s individual situation must be evaluated. Some general guidelines might be used to define “management.” The employee will not qualify as “management” if the employee provides merely support services.

Additionally, the executive should be in a position to influence the design and operation of the plan. The Department of Labor (DOL) provides some guidance in its informal Advisory Opinions. Generally, a select group of management would need to consist of individuals who have the “ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their ... plan taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protection of Title I” of ERISA.²⁰

One court case indicated that certain positions could be considered members of “management.” These positions include: “order processing manager, assistant general manager, director of purchasing and personnel, assistant controller, fleet equipment manager and assistant director of manufacturing.”²¹

Please note that this list represents only a single court’s opinion and is not recognized as authority by the DOL. Executive participation in the plan does not have to be limited to a strictly narrow group of a company’s top executives. The plan may be allowed to include a broad range of management or highly compensated individuals as long as the plan is not offered to “wildly varying levels” of employees.²²

Highly compensated

The “highly compensated” requirement is not defined by ERISA. Therefore, the facts and circumstances of the specific situation must again be evaluated in order to determine whether an employee is “highly compensated.”¹⁷ In contrast to ERISA, the IRC defines “highly compensated” in several sections. It is important to remember that the IRC does not define the “highly compensated” employee for ERISA purposes. However, the compensation threshold in IRC Section 414(q) might be considered an initial guideline.²³ Currently, this amount is \$155,000. So an employee needs \$155,000 in compensation in the 2024 tax year and were in the company’s top 20% in pay.

This amount is indexed for inflation on an annual basis. Any analysis of the “highly compensated” requirement must take into consideration all facts and circumstances. Although compensation levels less than the \$155,000 compensation threshold could fail to meet the “highly compensated” test,²⁴ the definition of “highly compensated” could vary from location to location.

A level of compensation in a rural area with a low cost of living may not be equivalent to a level of compensation in an urban area with a high cost of living. Therefore, the \$155,000 threshold could be adjusted upward or downward, depending on the actual circumstances. Also, please note that the \$155,000 threshold does not automatically qualify the executive for the “highly compensated” status. The DOL does not recognize the compensation threshold in IRC Section 414(q) as the definition of “highly compensated.”

In summary, as long as the executive bonus arrangement is only part of the individual employment agreements of select employees, it should not be an employee welfare benefit plan or pension benefit plan and not be subject to ERISA. However, if the executive bonus arrangement is considered an ERISA Plan, all ERISA requirements can be met as long as the executive bonus arrangement is for a select group of management or highly compensated employees.

Other considerations

Single and Double bonus

The employee is responsible for paying any income taxes associated with the executive bonus arrangement. However, the employee may not find the income taxes associated with the arrangement to be attractive. In this situation, the employer may pay an additional amount or bonus. In the first type, the “single bonus,” the employer pays the tax that is owed by the employee. Of course there is a tax on the single bonus, thus when the employer pays the tax plus the tax on the bonus, it is called a “double bonus.”

The double bonus refers to two bonuses. The first bonus is the initial bonus that has been previously discussed. The second bonus may be incorporated into the executive bonus arrangement and is used to pay the employee’s related income taxes. The second bonus will also be subject to income tax, which creates yet more tax that the employer might want to pay. If the employer wishes to pay all income taxes, the exercise results in a circular calculation, which the executive bonus arrangement software will solve.

Golden handcuffs

If the employer wants a more restrictive arrangement, a similar plan, called the golden executive bonus arrangement (GEBA) or golden executive match (GEM), could be used. Here the employer is restricting access to cash values in exchange for the payment of the employee’s tax. These arrangements are also called restricted executive bonus arrangements (REBA) or even leveraged executive bonus arrangements.

Under GEBA and GEM, the employee would become the owner of an insurance policy and designate the beneficiary. However, the employee and employer would execute a contract under which the employer would have a right to restrain the employee from exercising many of the ownership rights under the policy, such as accessing policy cash values, taking a loan against the policy and other ownership rights. As a result, the employee cannot access the life insurance cash values until the employee fulfills certain contractual obligations, such as working for the employer for a specified number of years.

Once the employee fulfills the contractual obligation(s) associated with the GEBA or GEM, the employer releases the life insurance contract access in full to the employee. Under the GEBA or GEM arrangements, the employer gains no ownership rights under the contract and the employee retains the freedom to change the beneficiary at will.

Employee contributions

An employee may contribute to the executive bonus arrangement; however, this should be carefully considered. If employee contributions are essential, the parties may want to consider a GEM arrangement. The GEM arrangement clearly specifies the amount that the employee contributes and the employer contributes a tax match.

Estate tax planning

If it is desired to exclude the insurance proceeds from the employee-insured's gross estate, the spouse or an irrevocable trust can be named owner.

The documents that follow assume that the executive bonus arrangement is a welfare benefit plan and qualifies for the top hat exemption. **Counsel is responsible for the actual wording and must draft and modify the documents to apply to a client's particular situation.**

Specimen Resolution Approving Executive Bonus Arrangement

COUNSEL ALONE IS RESPONSIBLE FOR THE ACTUAL WORDING OF THE FINAL RESOLUTION. NEITHER MINNESOTA LIFE INSURANCE COMPANY, SECURIAN LIFE INSURANCE COMPANY, NOR THEIR REPRESENTATIVES ARE ENGAGED IN THE PRACTICE OF LAW; THESE SPECIMEN ARRANGEMENTS ARE INTENDED FOR ILLUSTRATIVE PURPOSES AND COUNSEL MUST DRAFT A RESOLUTION APPROPRIATE FOR HIS OR HER CLIENT.

The undersigned, Secretary of _____ (hereinafter called the "employer"), does hereby certify that on the _____ day of _____, a meeting of the Board of Directors of said Corporation was called pursuant to the corporation's by-laws and a quorum was present, and the following resolution was unanimously adopted.

WHEREAS, _____, _____ and _____ are valuable and efficient employees; and WHEREAS, it is in employer's best interests to provide additional incentives to those key employees to keep them with the employer;

RESOLVED THAT the Board of Directors agrees to adopt an executive bonus arrangement in order to provide life insurance protection for the benefit of said employees effective as of _____.

Optional:

RESOLVED FURTHER, that in conjunction with this plan, the Corporation hereby awards

_____ and _____ bonuses of _____, _____ and _____, respectively.

Date

President

Secretary

Specimen Executive Bonus Arrangement

COUNSEL ALONE IS RESPONSIBLE FOR THE ACTUAL WORDING OF THE FINAL RESOLUTION. NEITHER MINNESOTA LIFE INSURANCE COMPANY, SECURIAN LIFE INSURANCE COMPANY, NOR THEIR REPRESENTATIVES ARE ENGAGED IN THE PRACTICE OF LAW; THESE SPECIMEN ARRANGEMENTS ARE INTENDED FOR ILLUSTRATIVE PURPOSES AND COUNSEL MUST DRAFT A RESOLUTION APPROPRIATE FOR HIS OR HER CLIENT.

This executive bonus arrangement is entered into on this _____ day of _____ by and between _____ (hereinafter called the "employer") and _____ and _____ (hereinafter "employees").

WHEREAS, the employees are valuable and contribute to the profitability of the employer.

WHEREAS, the employer wishes to reward the employees through a bonus arrangement, the specifics of which are contained herein.

NOW, THEREFORE, in consideration of the mutual covenants herein made, the employer and employees agree as follows:

1. Participation

_____, _____ and _____ are hereby determined to be eligible key employees of the employer for purposes of the executive bonus arrangement, and shall be entitled to participate in the arrangement for so long as they remain key employees of the employer.

2. Purchase of life insurance

_____, _____ and _____ shall apply to (Name of insurance company), (City), (State), for an insurance policy on the life of the employee and shall be designated sole owner of such policy. The policies shall be in the face amount of _____, _____, and _____, respectively.

3. Premiums

Premiums on said life insurance policies shall be paid by the employer as they become due. The employer shall pay the entire premium as additional salary to the employee. The maximum premium the employer will pay is _____ for _____, _____ for _____ and _____ for _____.

Notwithstanding anything to the contrary, the employer's obligations under this arrangement terminate at the earlier of the employee's death, disability, termination of service for any reason or the employee's attainment of age _____.

Optional:

The employer also agrees to pay the employees an additional cash bonus in an amount approximately equal to the additional amount of personal state and federal income taxes that the employee will incur as a result of this agreement.

4. Ownership

All rights of ownership shall be in the employee. No right of ownership shall be in the employer.

5. Supplemental agreements

If any policy is issued with a supplemental agreement providing for any additional death benefit, the additional premium for such supplemental benefit shall be paid by the employee. If any policy is issued with a waiver of premium, the employer shall pay the additional premium for the waiver of premium agreement. If any premiums are waived pursuant to such a waiver of premium provision, the executive bonus arrangement shall terminate as to the disabled employee as of the date upon which the first premium is waived or refunded.

6. Failure to purchase

If the employee does not exercise his or her right to purchase such policy within _____ days following eligibility to participate in this arrangement, the employer shall have no obligation to provide the additional compensation that would have otherwise been available under this arrangement.

7. Fiduciary provisions

(E.g., President of employer) is hereby designated as the named fiduciary of the executive bonus arrangement, and shall have the authority to control and manage the operation and administration of the executive bonus arrangement. Provided, however, that (Name of insurance company), (City), (State), shall be the fiduciary of the arrangement solely with regard to the review and final decision on a claim for benefits under its policy, as provided in CLAIMS PROCEDURE below.

8. Allocation of fiduciary responsibilities

The (named fiduciary) may allocate his or her responsibilities for the operation and administration of the executive bonus arrangement, including the designation of persons to carry out fiduciary responsibilities under any such arrangement. The (named fiduciary) shall effect such allocation of his or her responsibilities by delivering to the Corporation a written instrument signed by him or her that specifies the nature and extent of the responsibilities allocated, including the persons who are designated to carry out the fiduciary responsibilities under the particular arrangement or arrangements, together with a signed acknowledgment of their acceptance.

9. Termination rights

Either party may terminate this arrangement by giving the other party a written termination notice at least _____ days prior to the termination date. In any event, this arrangement will terminate upon the employee's death, permanent disability, separation from service for any reason or the employee's attainment of age _____.

Claims procedure

The following claims procedures shall apply to the executive bonus arrangement:

1. Filing of a claim for benefits

A participant or beneficiary shall make a claim for the benefits provided under a particular policy in the manner provided in that policy.

2. Claim denials

With respect to a claim for benefits under an insurance policy, (name of insurance company), (City), (State), shall be the entity that reviews and makes decisions on claims.

3. Notification to claim of decision

If a claim is wholly or partially denied, notice of the decision, meeting the requirements of paragraph "4" following, shall be furnished to the claimant within a reasonable period of time after the claim has been filed.

4. Content of notice

(Name of insurance company) shall provide to every claimant who is denied a claim for benefits written notice setting forth, in a manner calculated to be understood by the claimant, the following:

- A. The specific reason or reasons for the denial;
- B. Specific reference to pertinent policy or plan provisions on which the denial is based; and
- C. A description of any additional material or information necessary for the claimant to perfect the claim and an explanation of why such material or information is necessary.

5. Review procedure

The purpose of the review procedure set forth in this paragraph and in paragraph "6" following is to provide a procedure by which a claimant under employer's executive bonus arrangement may have a reasonable opportunity to appeal a denial of a claim to an appropriate named fiduciary for a full and fair review. To accomplish that purpose, the claimant or a duly authorized representative:

- A. May request a review upon written application to (name of insurance company);
- B. May review pertinent plan documents; and
- C. May submit issues and comments in writing.

A claimant (or a duly authorized representative) shall request a review by filing a written application for review at any time within sixty (60) days after receipt by the claimant of written notice of the denial of his or her claim.

6. Decision on review

A decision on review of a denied claim shall be made in the following manner:

- A. The decision on review shall be made by (name of insurance company), which may in its discretion hold a hearing on the denied claim. (Name of insurance company) shall make its decision promptly, unless special circumstances (such as the need to hold a hearing) require an extension of time for processing, in which case a decision shall be rendered as soon as possible, but not later than one hundred twenty (120) days after receipt of the request for review.
- B. The decision on review shall be in writing and shall include specific reasons for the decisions, written in a manner calculated to be understood by the claimant, and specific references to the pertinent policy or plan provisions on which the decision is based.

IN WITNESS WHEREOF, they have executed this executive bonus arrangement on this

_____ / _____.

Officer of employer

Employee

Employee

Employee

1. Treas. Reg. §1.61-2(d)(2)(ii)(A).
2. See e.g. Treas. Reg. §1.83-1(a)(2).
3. Treas. Reg. §1.61-2(d)(2)(ii)(A).
4. Treas. Reg. §1.83-3(e).
5. IRC §72(e)(1) B; IRS Reg. §1.72-11(b)(1).
6. IRS Reg. §1.451-2.
7. IRC §101(a); IRS Reg. §1.101-1(a).
8. IRC §72(e); IRS Reg. §1.72-11(d).
9. IRC §162(a); IRS Reg. §1.162-7; IRS Reg. §1.264-1(b); *Brown Agency, Inc.* 21 BTA 1111, Acq XI-1 CB 9; *Berizzi Bros. Co.* BTA 1307, Acq XI-1 CB 6; *Peerless Pacific Co.* 10 BTA 103.
10. 29 U.S.C. §1001-1381.
11. *Jervis v. Elerding*, 504 F.Supp. 606, 608 (C.D. Cal. 1980).
12. 29 U.S.C. §1002(3).
13. 704 F.Supp. 201 (D. Kan. 1988).
14. *Id.* at 204.
15. See *Williams v. Wright*, 927 F.2d 1540 (11th Cir. 1991); *Barrowclough v. Kidder, Peabody & Co., Inc.*, 752 F.2d 923 (3d Cir. 1985); *Murphy v. Inexco Oil Co.*, 611 F.2d 570 (5th Cir. 1980); *Jervis v. Elerding*, 504 F. Supp.606 (C.D. Cal. 1980); *Lackey v. Whitehall Corp.*, 704 F. Supp. 201 (D. Kan. 1988);
McQueen v. Salida Coca-Cola Bottling Co., 652 F. Supp. 1471 (D. Colo. 1987).
16. 611 F.2d 570 (5th Cir. 1980).
17. *Id.* at 574.
18. *Id.*
19. DOL Adv. Op. 92-13A (May 19, 1992); DOL Adv. Op. 90-14A (May 8, 1990).
20. DOL Adv. Op. 90-14A (May 8, 1990).
21. *Belka v. Rowe Furniture Corp.*, 571 F. Supp. 1249 (1983)
22. *Demery, et al. v. Extebank Deferred Compensation Plan, et al.*, 216 F.3d 283 (2nd Cir.2000), U.S. App. Lexis 13972, 24 E.B.C. 2095.
23. IRC Sec. 414(q)(1).
24. *Plazzo v. Nationwide Mutual Insurance Co.*, 697 F.Supp. 1437 (N.D. Ohio 1987).

Life insurance products contain charges, such as Cost of Insurance Charge, Cash Extra Charge, and Additional Agreements Charge (which we refer to as mortality charges), and Premium Charge, Monthly Policy Charge, Policy Issue Charge, Transaction Charge, Index Segment Charge, and Surrender Charge (which we refer to as expense charges). These charges may increase over time, and these policies may contain restrictions, such as surrender periods. Policyholders could lose money in these products.

Policy loans and withdrawals may create an adverse tax result in the event of lapse or policy surrender, and will reduce both the surrender value and death benefit. Withdrawals may be subject to taxation within the first 15 years of the contract. You should consult your tax advisor when considering taking a policy loan or withdrawal.

Please keep in mind that the primary reason to purchase a life insurance product is the death benefit.

Dividends are not guaranteed and may vary based on the actual experience of mortality, expenses, and investments.

Agreements may be subject to additional costs and restrictions. Agreements may not be available in all states or may exist under a different name in various states and may not be available in combination with other agreements.

This information is a general discussion of the relevant federal tax laws provided to promote ideas that may benefit a taxpayer. It is not intended for, nor can it be used by any taxpayer for the purpose of avoiding federal tax penalties. Taxpayers should seek the advice of their own advisors regarding any tax and legal issues specific to their situation.

This material provides you with education on how this life insurance policy can help you provide financial security for yourself and your family. It is not intended to apply to any person's individual circumstances and should not be considered investment advice. Securian and its subsidiaries are not recommending that anyone engage in (or refrain from) a particular course of action. If you are seeking investment advice or recommendations, please contact your financial professional.

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F71834-7 Rev 2-2025 DOFU 2-2025
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