A PRIMER ON 162 EXECUTIVE BONUS PLANS

The single source for your total executive benefit needs

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OVERVIEW

A 162 Executive Bonus Plan is a benefit plan that can be used to attract, retain, and reward Key Employees by providing valuable life insurance coverage along with the ability to accumulate and access assets on a tax efficient basis.

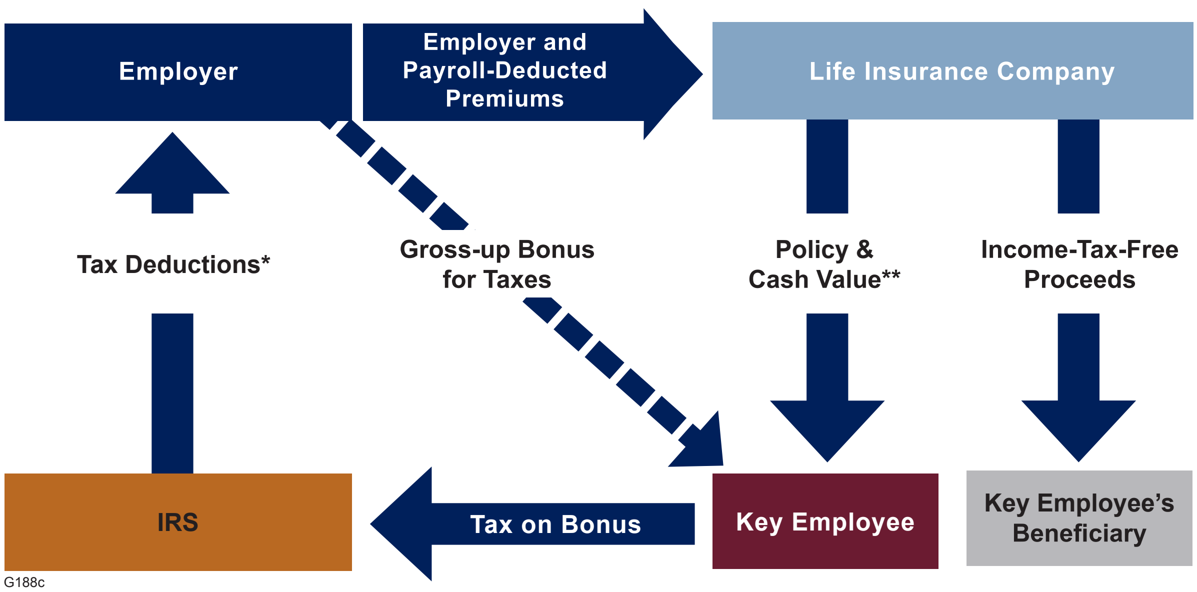
REASONS TO IMPLEMENT A 162 EXECUTIVE BONUS PLAN

- To attract, retain, and reward key executives
- To provide a benefit to specific, targeted employees
- To motivate the executive's job performance
- To help key employees replace retirement compensation lost as a result of limitations placed on qualified plans:
  - 401(k), 403(b), and 457(b) contribution limits
  - Discrimination testing restrictions on 401(k) and 403(b) plans

HOW IT WORKS

- The company pays the premium on a life insurance policy on the life of the Key Employee
  - Premium payments are taxable as ordinary income to the Key Employees at ordinary income rates
  - The company can choose to pay gross-up bonuses for taxes incurred
  - Premiums are treated as a compensation expense and are tax-deductible for income tax-paying entities
- Many plans allow for key Employees to contribute to policies via payroll deduction
- The Key Employee owns the life insurance policy which is fully payable to his or her designated beneficiary or beneficiaries as a tax-free death benefit
- The Key Employee can receive income through tax-favored withdrawals and loans from the policy's cash value
  - The Key Employee's basis in the contract is equal to the premiums paid. Therefore, taxation of policy withdrawals is the same as if the Key Employee had purchased the policy himself
  - A restrictive endorsement can be added to limit access to policy values prior to a vesting event in order to enhance retention

MECHANICS OF A TYPICAL 162 EXECUTIVE BONUS PLAN



*For tax-paying sponsors.
***Access restricted during restricted period.*

BENEFITS TO THE COMPANY

- Program aids in attraction, retention, and reward of key employees
- Benefit is simple to implement, explain, and administer
- Benefit can be offered on a selective basis
- Premium payments are generally deductible to tax-paying corporate sponsors
- Company has the flexibility to delay or stop future payments
- Vesting schedules can be used to enhance retention
- No liability is carried on corporate balance sheet
- No complicated tax, accounting, or compliance issues
- Plan is not subject to Section 409A

BENEFITS TO THE KEY EMPLOYEE

- Ability to leverage corporate “buying power” to access portable products, underwriting, and pricing, that may be unavailable to individuals
- Cash values grow on a tax-deferred basis (tax-free if held until death)
- Upon vesting, cash values can be accessed on a tax-free basis, subject to certain limitations, through withdrawals and loans to supplement retirement income
- High flexibility related to timing of access to cash values
- Distributions from the policies can occur before age 59½ without premature distribution penalties
- There are no required minimum distributions at age 70½ or thereafter
- Contributions to policies are not limited by qualified plan limitations
- Unlike deferred compensation plans, cash values are not subject to risk of forfeiture
- Upon the death of the Key Employee, all policy proceeds are paid tax-free to his/her beneficiaries
- Assists in estate planning. Death benefits can generally be arranged to be income and estate-tax free

DESIGN CONSIDERATIONS

Increasingly, key employees are basing employment decisions on the merits of their current or prospective employers' benefit programs. 162 Executive Bonus Plans provide the sponsoring corporation with great flexibility in design, allowing each plan to be structured to meet its specific objectives with respect to attracting, retaining, and rewarding key employees. Some of the most common customizable features used to this end:

PLAN OBJECTIVES*	● Attract ● Retain ● Reward ● Supplement income ● Provide a Death Benefit
PLAN DESIGN FEATURES	● Eligibility ● Contribution Types (Employer, Employee) ● Restricted Endorsement ● Policy Type (Variable, Indexed, Fixed) ● Contribution Years ● Underwriting (GI, SI, etc.) ● Limits (contributions, death benefits, issue age, etc.)

**All design features affect income replacement, attraction, reward, and retention to some extent. The extent to which objective is satisfied depends on each design feature and alternatives chosen.*

TAXATION

- At time of contribution:
  - Employer recognizes contributions as deductible compensation expense
  - Participant contributions are made on an after-tax basis. Employer contributions are taxable as income to the participant
- At time of distribution:
  - Because the policy is owned entirely by the employee, the company has no tax impact beyond the compensation deductions taken at time of premium payments
  - Participants can structure distributions from the policy to be tax-free via loans and withdrawals up to basis
  - Death benefits payable to the participant's beneficiary are always income tax free and can generally be arranged to be estate-tax free

THE RESTRICTED ENDORSEMENT

- Executed between employer and employee at time of policy issuance and filed with the insurance company
- Endorsement keeps executive from accessing the policy cash value until vesting. Prevents employee from:
  - Surrendering the policy for its cash value
  - Making cash withdrawals from the policy
  - Borrowing against the policy's cash value
  - Assigning or pledging the policy as collateral
  - Changing the ownership of the policy until retirement or a specific period of time
  - Executive retains the ability to change the beneficiary

BONUS 162 v. DEFERRED COMPENSATION

	Feature	Bonus 162 Plan	Deferred Compensation Plan
1	**Eligibility for Participation**	Any employee group, but select management/ highly compensated employees are most commonly included	Select group of management or highly compensated employees
2	**Sources of Contributions**	Employer provided bonus, paid directly to insurance contract as premium. Employee may contribute from other compensation sources as well. Company contributions can also include matching, 401(k) make-up and/or discretionary contributions.	Participant salary, bonus, commission; employer match, 401(k) makeup and/or discretionary contributions
3	**Vesting of Company Contributions**	Available, but requires use of restrictive endorsements	Common and easily administered
4	**Investment of Contributions**	Actual investment	Notional investment—bookkeeping accounts only
5	**Investment Options**	Dependent on the type of product purchased. Typically general (declared rate) or variable (fund options) account.	Fixed rate, variable rate (e.g., Moody's), benchmark fund returns
6	**Distributions**	Payable from the policy to the insured, via tax favored withdrawals of basis and loans	Payable from company cash flow to the insured
7	**Timing of Distribution**	Generally at discretion of insured, subject to restrictive endorsements	Elected at time of contribution. Future changes are restricted.
8	**Death Benefits**	Any death benefit value remaining in the insurance policy is payable tax-free to the named beneficiary	Any unpaid balance in the plan is typically paid to the beneficiary as a taxable lump sum
9	Funding Asset	Life insurance	Funding not required, but recommended. Life Insurance is a common informal funding vehicle.
10	**Funding Asset Owner**	The Insured	The Company
11	**Security**	Medium to high—policy is owned by the insured. Restrictive endorsements may limit the participant's ability to reallocate, or take distributions until a vesting period is reached.	Low to medium—funding asset is owned by the company and is subject to its general creditors in a financial downturn or bankruptcy. Grantor trust can protect assets from change in control and change of heart.
12	**Timing of Taxation, In General**	Usually only at time of contribution. No tax on distributions via policy loans; tax can be avoided on policy withdrawals if structured properly.	At time of benefit payout
13	**Employee Taxation of**		
	▪ Contributions	Contributions are subject to FICA and income tax	Contributions are subject to FICA at the time of contribution or vesting, but not to income tax
	▪ Earnings	Cash values grow tax-deferred (tax-free if held until death)	Earnings are tax deferred
	▪ Distributions	Policy loans are not taxable. Withdrawals up to basis are not taxable if structured properly.	Distributions (contributions and earnings thereon) are not subject to FICA, but are subject to income tax

	Feature		Bonus 162 Plan	Deferred Compensation Plan
14	**Employer Taxation of**			
	■	Contributions	Contributions are deductible at time of contribution, and then are off the books of the company	No compensation deduction at time of contribution, but tax-paying employers may book a future tax credit for earning purposes
	■	Earnings	None	Credit for earnings is realized at time of payout
	■	Distributions	None	Employer deducts total distribution (contributions plus earnings) as compensation
15	**Employer Cash Flow Impact**			
	■	Contributions	Employer provided bonus and gross-up, if any, is a negative cash flow. Tax deduction on these amounts is a positive cash flow.	Employee contributions are a positive cash flow item. "Lost" tax deduction is a negative cash flow.
	■	Earnings	None	None until payout. See Distributions below.
	■	Distributions	None	Distributions (contributions and earnings) are a negative cash flow item. Tax deduction on distribution amount is a positive cash flow.
16	**Employer P&L Impact**			
	■	Contributions	Employer provided bonus and gross-up, if any, is an incremental compensation expense	Employer contributions are an incremental compensation expense
	■	Earnings	None	Earnings credited to participant balances is a compensation expense
	■	Distributions	None	None
17	**Employer Balance Sheet Impact**		Cash is reduced by premiums paid	A liability is carried for the account balances
18	**Regulatory/Legal Requirements**		Plan document outlining claims procedures required and must be available upon DOL request	Plan document required. DOL reporting limited to one-time filing at plan inception. SEC reporting may be required. COLI assets are required to be reported annually to the IRS on Form 8925.
19	**ERISA Treatment**		IRC 162 Executive Bonus Plan. Usually "non-qualified." If not a "Top Hat" only plan, ERISA requirements apply.	IRC 409(A) plan; always "nonqualified," e.g., not subject to most ERISA requirements

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