HAVE YOUR CAKE AND EAT IT TOO: "GOLDEN HANDCUFFS" WITH INCOME TAX DEDUCTION

GF Pastas, LLC is a closely held company specializing in gluten-free pastas for the restaurant industry. While they've been successful in placing their products in local restaurants, after they hired Fritz - a former executive chef with national contacts - GF Pastas experienced a significant increase in sales. GF Pastas would like to incentivize Fritz to remain with the company but doesn't want to give him equity. Since current income tax deductibility is an important consideration for GF Pastas' shareholders, their financial advisor suggests an executive bonus plan (EBP) might provide a simple solution.

WHAT IS AN EBP?

With an EBP the employer pays all or part of the premium on a life insurance policy for a key employee under a "bonus" arrangement. The bonus is tax-deductible to the employer under IRC § 162.* The key employee is the insured and the owner of the policy. The plan offers the key employee immediate death-benefit protection, tax-deferred growth of policy values and a potential source of tax-free retirement income in the future.

The twist comes in with GF Pastas entering into an additional arrangement with Fritz, loaning him his annual income tax outlay on the premium bonus plus accrued interest. A collateral assignment on the policy secures the loan arrangement and provides a "golden handcuff" on Fritz.

GF PASTAS' EBP WITH A TWIST

However, GF Pastas' shareholders are concerned that the EBP doesn't provide enough of a "golden handcuff" on Fritz. GF Pastas' advisor suggests a "twist" on the traditional EBP that preserves the current income tax deduction for the premium bonus, while sweetening the arrangement with current tax-free benefits for Fritz and a "golden handcuff" for GF Pastas. The twist comes in with GF Pastas entering into an additional arrangement with Fritz, loaning him his annual income tax outlay on the premium bonus plus accrued interest. A collateral assignment on the policy secures the loan arrangement and provides a "golden handcuff" on Fritz.

GF Pastas enters into an employment agreement with Fritz. At the same time, GF Pastas and Fritz enter into a discretionary bonus arrangement. GF Pastas plans to bonus Fritz $50,000 annually for up to 15 years. Fritz will use the $50,000 to pay the premium on a cash accumulation IUL policy. At the same time, GF Pastas enters into a loan agreement with Fritz, in which they agree to loan him annually an amount equal to his income tax liability on any bonus. The loans will accrue interest at the appropriate AFR rate and become due at the earlier of his retirement or termination from GF Pastas. A collateral assignment on the policy with the life insurance carrier will secure the cumulative loans advanced to Fritz.

During the terms of the bonus and loan arrangements, Fritz will incur no out-of-pocket costs. If Fritz remains with GF Pastas for 15 years, he can take a withdrawal from his life insurance policy values to repay the accumulated loan to GF Pastas, and they'll release the collateral assignment on the policy. Thereafter, Fritz can take tax-free withdrawals/loans from the policy to supplement his retirement income.

Let's assume Fritz is a preferred plus nonsmoker and the indexed universal life policy credits 7.35 percent annually. Further, the AFR rate in the first year is 3 percent and increases 25 bps annually to a maximum of 4 percent. Fritz retires from GF Pastas at age 65, takes a withdrawal to repay his cumulative loan and also takes 15 years of supplemental retirement income tax-free from the policy values. The following chart summarizes the projected costs and benefits of the proposed EBP with a twist for Fritz. Fritz's current tax bracket is 32 percent.

EBP with a Twist

				Income Tax Loan					Policy Values			Employee	
Yr	Age (EOY)	Premium Bonus	Income Tax on Bonus @ 32%	Annual Loan (EOY)	Note Repayment (BOY)	Annual Interest Rate	Annual Interest Accrual	Cumulative Loan (EOY)	Net Outlay	Net Cash Value	Net Death Benefit	Annual Net Outlay	Cumulative Net Outlay
1	51	50,000	(16,000)	16,000	0	3.00%	0	16,000	(50,000)	15,222	924,440	0	0
2	52	50,000	(16,000)	16,000	0	3.25%	480	32,480	(50,000)	64,560	963,802	0	0
3	53	50,000	(16,000)	16,000	0	3.50%	1,056	49,536	(50,000)	111,862	1,010,108	0	0
4	54	50,000	(16,000)	16,000	0	3.75%	1,734	67,269	(50,000)	164,569	1,061,816	0	0
5	55	50,000	(16,000)	16,000	0	4.00%	2,523	85,792	(50,000)	223,190	1,119,441	0	0
10	60	50,000	(16,000)	16,000	0	4.00%	6,732	191,040	(50,000)	603,180	1,492,448	0	0
15	65	50,000	(16,000)	16,000	0	4.00%	11,657	319,091	(50,000)	1,188,972	1,522,358	0	0
16	66	0		0	(319,091)	4.00%	0	0	419,684	836,463	1,102,674	100,593	100,593
20	70	0	0	0	0	4.00%	0	0	100,593	690,130	812,339	100,593	502,965
25	75	0	0	0	0	4.00%	0	0	100,593	434,398	508,227	100,593	1,005,930
30	80	0	0	0	0	4.00%	0	0	100,593	41,319	104,947	100,593	1,508,895

THE BOTTOM LINE

For no effective out-of-pocket cost to him, Fritz is projected to receive $1.5 million tax free in lieu of equity in GF Pastas. An EBP with a twist may be the perfect win-win providing a key employee with a tax-free benefit package while giving the business both a "golden handcuff" and the ability to take a level of current income tax deduction. An EBP with a twist can provide significant death benefits and tax-advantaged cash value accumulation as a substitute for shareholder's equity.

* The deductibility of the bonus is subject to the reasonable compensation limits established by IRC § 162(a).