



**PETER VILIESIS**  
*The Executive Benefits Guy*

Creative Strategies, Resources and Solutions

*CREATING, MANAGING, AND PROTECTING WEALTH OF BUSINESS OWNERS, KEY  
EXECUTIVES AND PROFESSIONALS*

## **MANAGEMENT SECURITY PLAN**

**AN IRC SECTION 162(A) INSURED BONUS ARRANGEMENT  
FOR KEY EMPLOYEES**

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### *Insurance Products:*

- *any illustrated guarantees are only backed by the claims-paying ability of the issuing insurance company;*
- *are not a deposit or other obligation of or guaranteed by, any bank or bank affiliate;*
- *are not insured by the FDIC or any other federal government agency, or by any bank or bank affiliate; and*
- *are subject to investment risk, including possible loss of value.*

*For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).*

Past performance cannot predict future results. The purpose of this discussion outline is to present the issues and plan mechanics associated with an Executive Bonus Plan. The insurance product shown in this report is representative of the market and is based on a hypothetical investment yield which is not guaranteed. Actual results will be different from those shown here.

# THE MANAGEMENT SECURITY PLAN – AN IRC SECTION 162(A) INSURED BONUS ARRANGEMENT FOR KEY EMPLOYEES

## Executive Summary

A Management Security Plan is an IRC Section 162(a) Bonus Plan arrangement that can provide significant death benefits and cash value accumulation for key employees. Because it is a simple and straightforward way to reward a key employee over and above traditional salary and other benefits, this plan is a popular strategy for delivering supplemental benefits. Using this method, the corporation pays the premium for a life insurance policy owned by the employee. The premium payment is considered a bonus and results in ordinary income for the employee and is taxable at normal income tax and other payroll tax rates. The premium payments made by the employer are tax deductible to the company (as it is paid to the insurance carrier). Participation in the Management Security Plan is voluntary for the key employees.

Contributions elected by the participant will be deducted from their annual salary on an after-tax basis and paid as premium to the policy. For employees who elect to participate, the company will pay the initial minimum policy premium as long as the participant is an employee of the company. In addition, the company may make discretionary contributions directly into the policy to offset the taxes paid by the employee for their contribution and any company contributions.

In order to participate, employee's will need to meet certain minimum health requirements to qualify for the life insurance, and agree to make at least the annually required minimum contribution each year (as determined by the plan sponsor) and restrictions may apply to the maximum amount of contribution that may be made in any given year.

## KEY FEATURES

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- The employer and the employee enter into an agreement under which the employee agrees to contribute a portion of their compensation, and the employer agrees to pay a discretionary bonus which is used to pay the premium on a life insurance policy. The employer's contribution equals the minimum amount needed to maintain the policy, and may also include an additional amount needed to make the key employee's contribution equal to a pre-tax, 401(k)-like deferral amount.
- The policy can be owned either by the key employee or a third party such as an irrevocable trust. The employee has most of the normal rights of a policy owner, including naming a beneficiary, but also enters into a Modification of Ownership Rights agreement that limits their rights to access policy cash values while employed, providing the employer with some "golden handcuffs" on their executives.
- The death benefit proceeds payable under the policy will be paid to the participants' designated beneficiary(ies) under the policy. It is agreed that the company shall not be entitled to receive any death benefit proceeds.

## **INSURED 162 BONUS PLAN COMPARED TO OTHER SAVINGS OPTIONS**

### **Taxable Investments**

Taxable investments have the potential to accumulate cash and can be accessed at any time. Investors may make unlimited distributions and withdrawals. Taxable investments may be subject to income and capital gains tax each year or at the time of withdrawal.

### **Qualified Plans / Traditional IRAs / Roth IRAs**

Qualified Plans, such as employer retirement plans and traditional IRAs, usually comprise the majority of assets in a retirement portfolio. Both qualified plans and traditional IRAs have age requirements and restrict the amount of money that can be contributed annually. Distributions cannot be taken until age 59 ½ and must be taken by age 70 1/2. Early distributions are subject to a 10% penalty as well as income taxes. Roth IRAs are another good savings vehicle. Money is contributed to a Roth IRA account on an after-tax basis and grows income tax free. Like traditional IRAs, Roth IRAs have income restrictions for eligibility but do not have a set distribution age of 70 ½. Distributions can be taken income tax free, anytime after age 59 ½.

### **Municipal Bonds**

Municipal bonds are generally free from federal income tax. They are debt securities of a municipality and are not subject to state income taxes if owned within the state of issue. Municipal bonds are not subject to contribution restrictions and accumulate on a tax-deferred basis. Municipal bonds are a great investment choice for individuals in the highest income bracket. However, municipal bonds yield a low rate of return compared to other investments.

## MANAGEMENT SECURITY PLAN – DETAILS

### ADVANTAGES AND TAXATION ISSUES FOR THE EMPLOYEE

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- Policy cash values grow tax deferred and if properly structured, may be received tax free. This provides a tax advantaged way for the employee to save for retirement or other financial goals.
- Contributions made by the employer are considered ordinary income for the participant and must be reported in the year received (IRC Section 61(a)(1)). Amounts are reported on Form W-2 as an adjustment.
- Bonuses are subject to current federal income tax. Employer may bonus an additional amount, a “double bonus” to cover the taxes on the bonus, including the additional bonus.
- Employees must pay Social Security and Federal Unemployment taxes on bonus amounts.
- Contributions made by the participant are made on an after-tax basis.
- If properly designed, life insurance policy distributions are not subject to a 10% penalty for withdrawals prior to age 59 ½.
- Death benefit proceeds would be includable in the gross estate unless a third party trust was properly established (IRC Section 2042).

### ADVANTAGES AND TAXATION ISSUES FOR THE EMPLOYER

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- Provides a way for the company to attract, reward, and retain key talent.
- Freedom to select from among highly compensated key employees and to provide different benefits levels to different groups.
- Simple to set up and administer; IRS approval is not required and these plans avoid many of the costs and complexities of complying with ERISA.
- Premium payments made by the employer are generally considered current compensation to the employee.
- The payment of the bonus is normally deductible to the employer if the bonus is an ordinary and necessary business expense and made in good faith as additional compensation for services rendered (IRC Section 162(a)).
- The bonus must fall within the reasonable compensation rules (Treas. Reg. Section 1.162-9).

## **MODIFICATION OF OWNERSHIP RIGHTS**

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The program is structured around the purchase of a specially designed variable life insurance policy that will be owned by the participant. A Modification of Ownership Rights will be executed by the Participant detailing the ownership rights and duties under the policy while the plan is maintained. The modification creates “handcuffs” on the key employees by limiting their access to policy cash values until certain milestones or time frames are met. The Modification of Rights prohibits the participant from:

- a) surrendering the Policy for its cash value,
- b) obtaining a loan or withdrawal from the Policy,
- c) assigning the Policy as collateral for security,
- d) changing the ownership of the Policy by endorsement, assignment or modification, or
- e) to exercise any other right, privilege, option or benefit granted by the Policy to the owner during the lifetime of the Insured, except as permitted by the Company.

The Release of the Modification of Rights will terminate upon the earlier of the attainment of age sixty (60), termination of employment with the company, performance of all of its terms following your death, written notice from one party to the plan agreement to the other with thirty (30) days notice, company's bankruptcy, receivership, dissolution or total cessation of business for any reason whatsoever, any action by one party to the plan agreement that would defeat or impair the interest of such other party other than death or termination of employment with the company.

## **ERISA ISSUES**

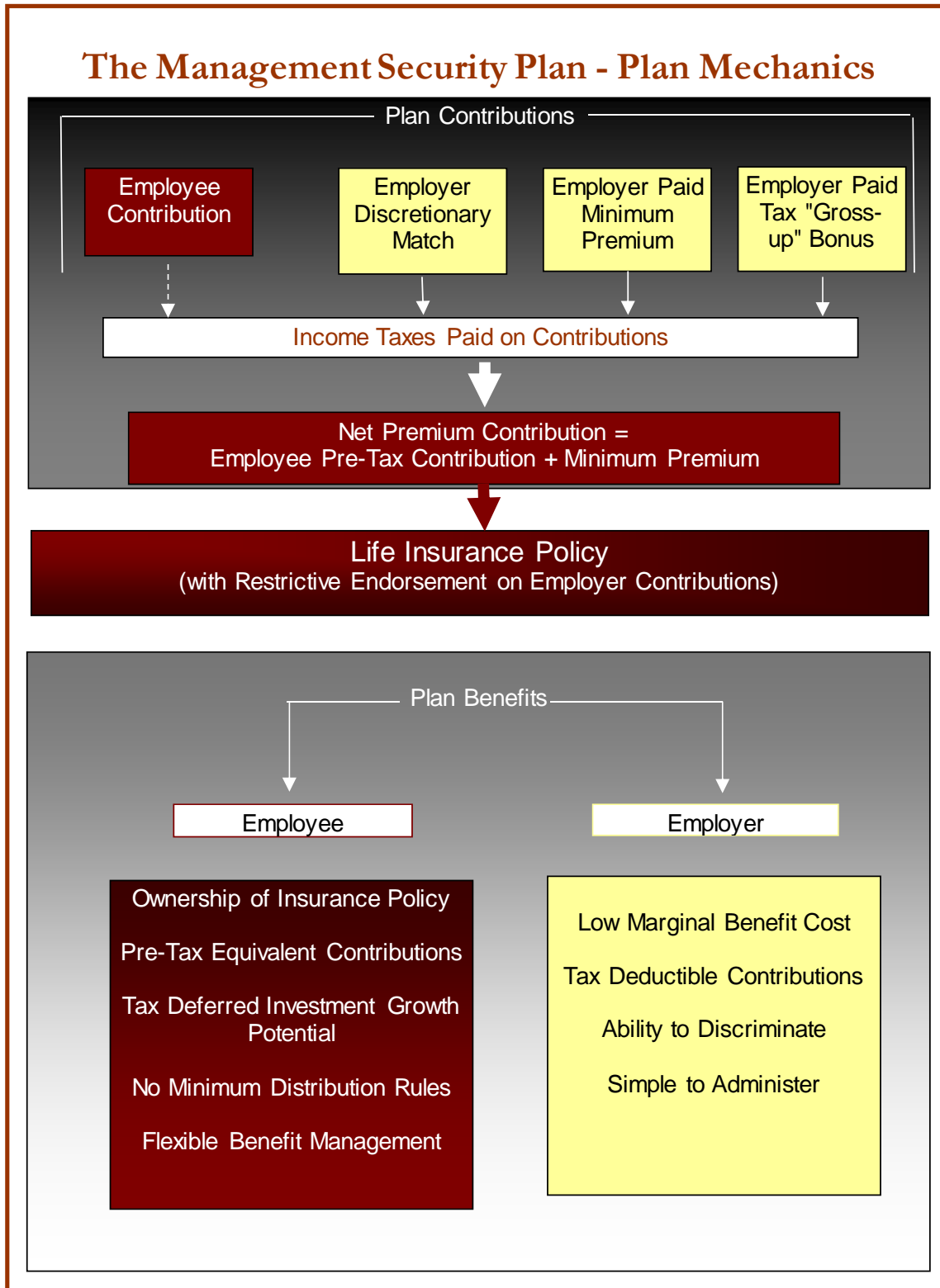
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A Management Security Plan bonus design may require compliance with ERISA by the employer. Whether ERISA applies, and what degree of compliance is required hinges on the bonus design. If the bonus is structured as a cash bonus, i.e., the employee has the choice between taking the bonus in cash or having it paid into the insurance policy, compliance may not be required since cash bonuses are generally not covered under ERISA. However, if the employer is making premium payments directly to the insurer, the bonus is more likely to be considered part of a welfare benefit plan.

Welfare benefit plans are required to comply with Parts 1, 4, & 5 of Title I of ERISA. This usually entails reporting and disclosure (Part 1), fiduciary responsibility (Part 4), and claims procedures (Part 5). The extent of compliance under Title I depends on the employees covered under the plan. If the bonus is noncontributory and is limited to a select group of management or highly compensated employees (called the top hat group), the only ERISA requirement is to make plan documents available to the Department of Labor at their request. When a plan is extended beyond the top hat group, additional reporting and disclosure is required. For plans of less than 100 employees, a summary plan description is needed. Plans covering 100 or more employees require full Part 1 compliance which includes, but is not limited to, Form 5500 reporting, summary annual reports, and a summary plan description. All forms of welfare plans must comply with the fiduciary and claims procedure requirements of Parts 4 & 5 of Title I.

## MANAGEMENT SECURITY PLAN MECHANICS

There are many variations on how a company can set up a 162 bonus plan. They range from merely facilitating the acquisition of institutionally priced life insurance and the forwarding of employees' contributions all the way up to paying "double bonuses" to the participants so that their contributions are equivalent to a pre-tax contribution into a 401k plan.





## How It Works, A One-Person Example

Management Security Plan - Contribution Mechanics								Hypothetical Policy Values		
Year	Age EOY	Pre-Tax Executive Elective Contribution	Employer Minimum Premium	Pre-Tax Employer Match	Employer Tax Gross-up Bonus	Executive Taxes Paid	Total Policy Premium	Premium	Net Cash Surrender Value	Death Benefit
1	46	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	8,084	331,195
2	47	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	19,148	340,646
3	48	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	30,271	350,044
4	49	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	41,615	359,988
5	50	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	53,167	370,502
6	51	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	65,263	381,996
7	52	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	77,849	394,142
8	53	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	90,902	406,981
9	54	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	104,577	420,554
10	55	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	118,947	434,896
11	56	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	135,598	453,288
12	57	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	153,097	472,724
13	58	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	172,138	493,265
14	59	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	193,802	514,929
15	60	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	216,683	537,810
16	61	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	240,831	561,958
17	62	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	266,355	587,482
18	63	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	293,336	614,463
19	64	10,000	2,500	2,500	1,667	(4,167)	12,500	12,500	321,851	642,978
		190,000	47,500	47,500	31,673	(79,173)	237,500	237,500		

Hypothetical Insurance Policy Crediting Rate: 6.00% Gross S&P 1 Year Index Account  
Insurance Values assume Female GI Executive Non-smoker Rates

**Values shown are hypothetical and for informational purposes only and not intended to replace the use of an insurance illustration. The figures shown here are non-fixed assumptions, are not guaranteed, and are not likely to occur. Actual results will be higher or lower than those shown here. Please refer to an actual policy illustration and prospectus for important information about the insurance policy.**

### Hypothetical Life Insurance Illustration Assumptions:

- Key Executive Salary = \$100,000
- Executive Assumed Effective Net Tax Rate: 25%
- Executive Pre-Tax Elective Contribution: 10% (\$10,000)
- Employer Minimum Premium Contribution: \$3,500
- Employer Double Bonus Tax Gross-up: \$4,500
- Cash value of life insurance grows tax deferred
- Flexible options for using policy values include (but are not limited to):
  - Provide tax-free income via withdrawals to tax basis and loans,
  - Annuitization,
  - Policy can be wholly or partially surrendered. (Policy values withdrawn or surrendered in excess of cumulative premiums paid would be considered taxable income to the employee and would reduce the cash value and death benefit of the policy.)
  - Policy can be converted to reduced paid-up status for death benefit.

## About The Firm

**The Executive Benefits Guy** is an independent consulting firm bringing innovative new ideas and solutions for creating, managing, and protecting wealth of business owners, key executives and professionals. Our unique focus is on small to mid-size corporations that are challenged in today's global economy to provide competitive compensation programs to insure the retirement security of their key people, and to perpetuate the smooth transition and exit strategies for the owners.

Peter Vilieis, CLU, ChFC, as founder and principal of **The Executive Benefits Guy**, brings over 25 years of experience in the design and implementation of executive benefit strategies to corporations and closely held businesses, and the development of appropriate financing solutions for these programs. Peter also helps guide business owners through exit strategies designed to help meet their desired outcomes for establishing retirement wealth, transferring control, and preserving the financial stability of the organization through the transition process.