

2025 ADVANCED SALES FORUM

Explore, Inquire, Innovate

Life Insurance Bonus Plans *ERISA and Tax Implications*

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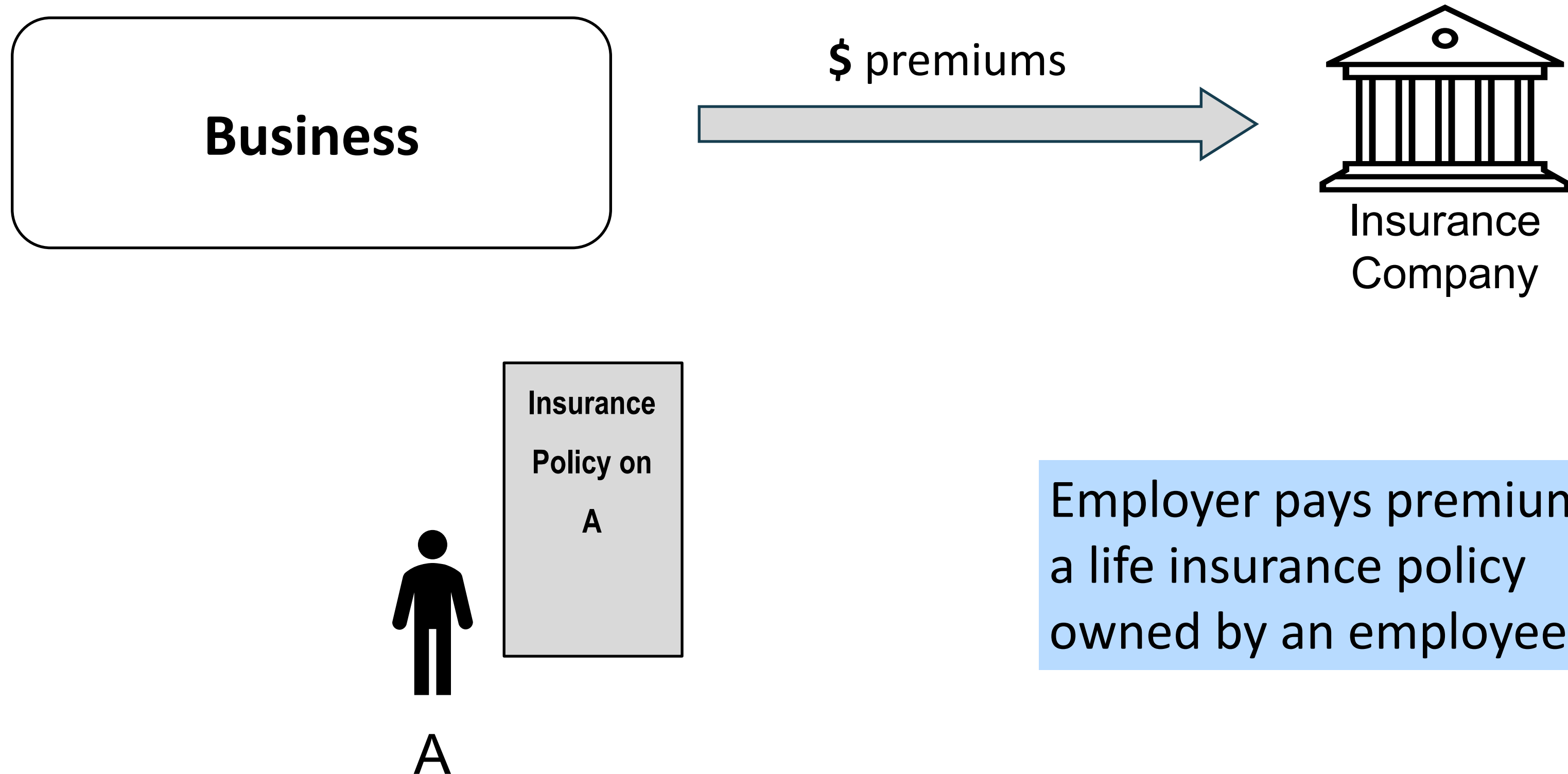
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Sr. Advanced Sales Specialist

National Life



Bonus Plan . . . the basic set-up



Employer pays premiums for a life insurance policy owned by an employee

What we hope to cover today

1. Civil Rights Act of 1964 (Title VII) – generally requiring sex-neutral or unisex rates, rather than sex-distinct rates
2. Potential ERISA application (welfare benefit and pension plans)
3. Taxation – including with “restricted” bonus plans

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Anti-sex discrimination law in employment context

- Title VII of the Civil Rights Act of 1964
 - Codified as 42 U.S.C. § 2000e-2.
 - Prohibits discrimination by employers on basis of race, color, religion, sex, or national origin
 - Applies to any employer who has 15 or more employees (even if fewer than 15 employees participate in the plan).
- *Arizona Governing Committee v. Norris*, 463 U.S. 1073 (1983)
 - All retirement plan benefits, must be calculated without regard to the sex of the participants.
 - Might be interpreted to mean that any arrangement that is a “privilege of employment” must not be sex biased.
 - **As such, any life insurance policy purchased for employees in connection with an employee fringe benefit plan perhaps should have unisex / sex-neutral rates.**
- Many states have passed fair employment law with similar prohibitions against sex discrimination and apply these laws to employers with fewer than 15 employees.

Example

- Bob and Susan are fraternal twins, age 45
- They are the star employees at ABC company
- The owner wants to offer them an executive bonus plan
- \$10,000 premium for 10 years to fund a life insurance policy
- Intended for death benefit protection and potential supplemental income at age 65
- Is there a sex-distinct / sex-neutral issue?

Example (cont'd)

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- Is there a sex-distinct / sex-neutral issue?

Male		Female
\$286,000	Death Benefit *	\$318,000
\$219,000	Cash Value age 65 *	\$225,000

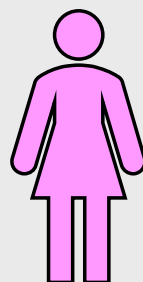
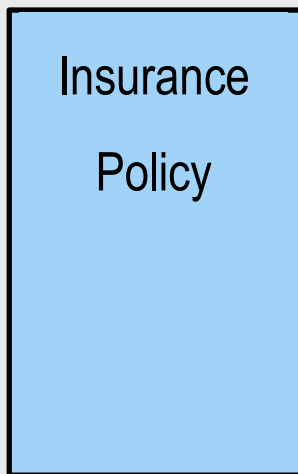
* Hypothetical values – Does not reflect any particular life insurance product

SEX-DISTINCT

**If premiums are equal,
Susan's policy is larger**

\$

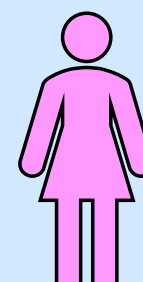
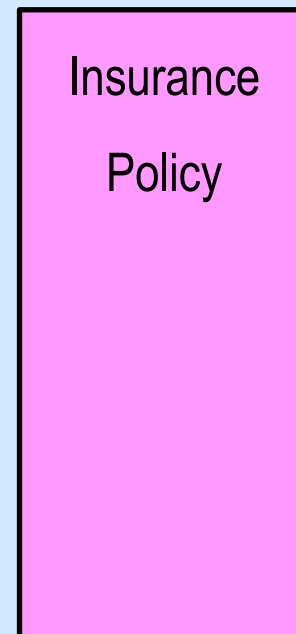
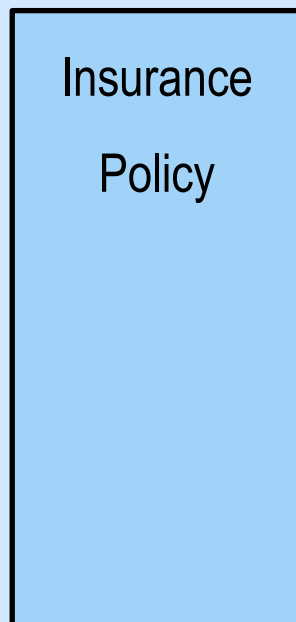
\$



**If policies are equal,
Bob gets larger premiums**

\$

\$

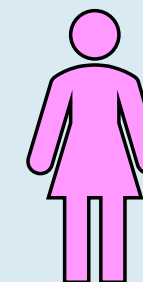
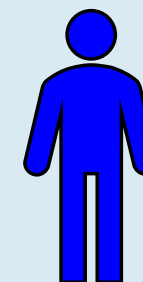
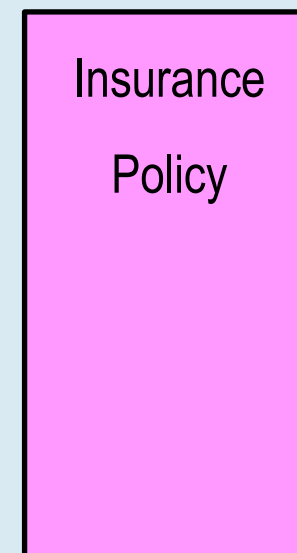
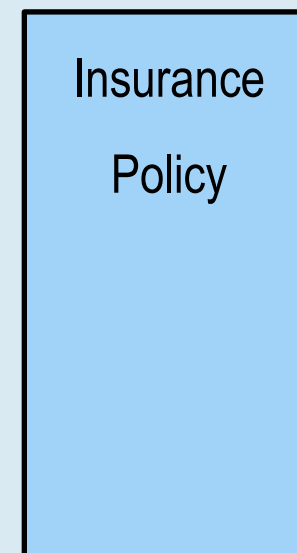


SEX-NEUTRAL

**Sex-neutral policies provide
equal premium and equal policy size**

\$

\$



Second – potential application of ERISA

1. Civil Rights Act of 1964 (Title VII) – generally requiring sex-neutral or unisex rates, rather than sex-distinct rates
2. Potential ERISA application (welfare benefit and pension plans)
3. Taxation – including with “restricted” bonus plans

ERISA - Employee Retirement Income Security Act of 1974

ERISA is organized in four Titles:

- Title I contains the labor law provisions and applies to all plans subject to the Act.
- Title II codifies rules for qualified pension plans such as 401(k) plans and are put forth in the Internal Revenue Code (IRC).
- Title III assigns responsibilities for enforcement and administration to the Departments of Treasury and Labor.
- Title IV establishes the Pension Benefit Guaranty Corporation (PBGC) to administer an insurance program for defined benefit pension plans.

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Title I is the only Title that applies to *nonqualified* employee benefit plans.

Title I of ERISA divides employee benefit plans into two types

- A welfare plan is defined in ERISA § 3(1) (29 U.S. Code § 1002(1)) as:

... [A]ny plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program **was established or is maintained for the purpose of providing** for its participants or their beneficiaries, **through the purchase of insurance or otherwise**, (A) medical, surgical, or hospital care or benefits, or **benefits in the event of** sickness, accident, disability, **death** or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in Section 302(c) of the Labor Management Relations Act, 1947 (other than pensions on retirement or death, and insurance to provide such pensions).

- A pension plan is defined in ERISA § 3(2) (29 U.S. Code § 1002(2)) as:

... [A]ny plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program —

- **provides retirement income** to employees, or
- results in a **deferral of income** by employees for periods **extending to the termination of covered employment** or beyond,

regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

ERISA exceptions

ERISA Applies Only to “Employees”

- A plan is not subject to ERISA if the plan does not cover employees.
- Per 29 C.F.R. § 2510.3-3(b), a plan does not cover any “employees,” and thus **ERISA does not apply, if the plan covers *only*:**
 - the sole owner of a business, whether or not incorporated, and the owner’s spouse, or
 - partners and their spouses.

Plans Not Covered Under ERISA (ERISA § 4; 29 U.S. Code § 1003)

- government plan
- church plan that has not elected to be covered
- plan maintained solely to comply with worker’s compensation, unemployment compensation, or disability insurance laws
- plan maintained outside the United States primarily for non-US resident aliens
- unfunded “excess benefit plan”
- group or group type plan that meets certain restrictive conditions

Why bonus plans might not be “welfare benefit plans?”

- **To be a “plan” under ERISA, there must be an “ongoing administrative scheme.”**
 - *Fort Halifax Packing Company, Inc. v. Coyne*, 481 U.S. 1 (1987).
 - One-time severance was an employee “benefit” but was not a “benefit plan.”
 - Subsequent cases not entirely consistent, but usually escape having ongoing administrative scheme only if employer has no discretion, and payment is triggered by single event and made in lump sum (or very few payments).
 - Do bonus plans have an ongoing administrative scheme?
- **Do plans for just 1 employee avoid ERISA?**
 - *Dakota, Minnesota & Eastern Railroad Corp. v. Schieffer*, 648 F. 3d 935 (8th Cir. 2011).
 - The words “plan” and “program” in 29 § 1002(1) strongly imply benefits that an employer provides to a class of employees.
 - But sometimes a benefit for just 1 employee is subject to ERISA.
 - *Duggan v. Hobbs*, 99 F.3d 307, 310 (9th Cir. 1996).
 - *Zgrablich v. Cardone Industries, Inc.*, 61 EBC 2650 (E.D. Pa. 2016).

If bonus plan is welfare benefit plan, what is required?

- **Any welfare benefit plan must be in writing. ERISA § 402(a)(1) (29 USC § 1102(a)(1)).**
- **What must the plan contain? (usually done in a few paragraphs in the written bonus plan)**
 - Claims procedure. Tell participants the method of filing a claim for benefits and the procedure used to appeal any denial of a claim. ERISA § 503 (29 USC § 1133).
 - Fiduciary elements. ERISA § 402 (29 USC § 1102):
 - Name a fiduciary
 - Funding policy
 - Allocation of fiduciary responsibilities
 - Amendment procedure
 - Basis for payments
- **What else is required? Reporting and Disclosure. ERISA §§ 101-111 (29 USC §§ 1021-1030a)**
 - Annual report, Form 5500 (filed with the IRS, which forwards a copy to the Dept of Labor)
 - Terminal Reports
 - Summary annual report to participants
 - Description of material modifications to participants
 - Summary plan description
 - Provide plan documents to Dept of Labor upon request

Good news: if less than 100 participants, then less required

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Some of these requirements disappear if:

- Less than 100 participants, and
- Benefits paid from:
 - employer's general assets, and/or
 - insurance policies paid for by employer

See 29 C.F.R. § 2520.104-20

Even better news! if only Top Hat employees, even less required

- Any welfare benefit plan must be in writing. ERISA § 402(a)(1) (29 USC § 1102(a)(1)).
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Even more of these requirements disappear if:

- For select management or highly paid, and
- Benefits paid from:
 - employer's general assets, and/or
 - insurance policies paid for by employer

See 29 C.F.R. § 2520.104-24

Conclusion:

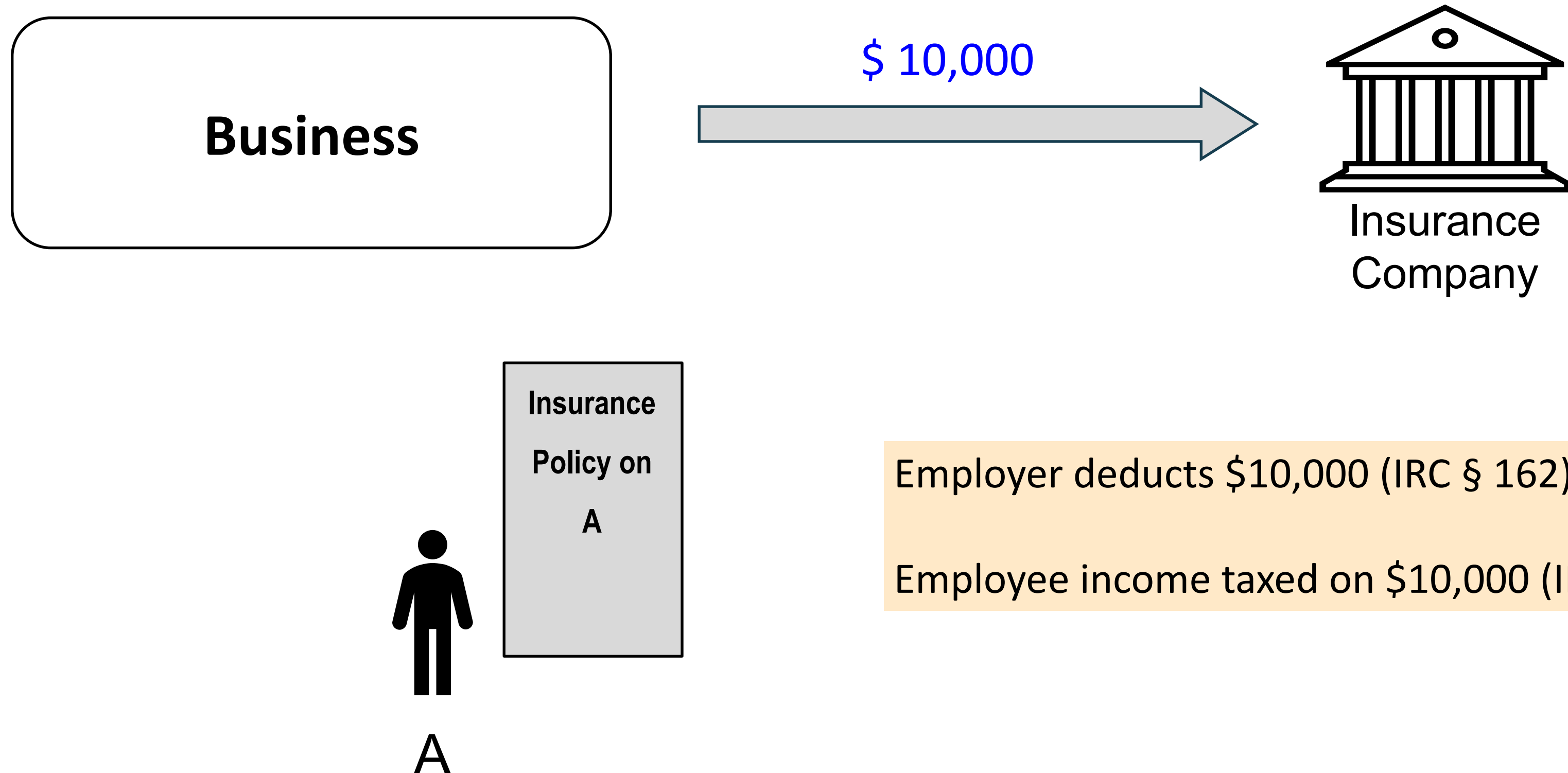
For the many bonus plans that benefit select management or highly paid employees, most ERISA requirements can be satisfied by well-drafted bonus plan agreements (that are drafted by the attorneys for the clients).

The bonus plan agreement is separate from and in addition to the employee-owned life insurance contract.

Third – taxation

1. Civil Rights Act of 1964 (Title VII) – generally requiring sex-neutral or unisex rates, rather than sex-distinct rates
2. Potential ERISA application (welfare benefit and pension plans)
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Bonus Plan income taxation



Employer deducts \$10,000 (IRC § 162)

Employee income taxed on \$10,000 (IRC §§ 61, 451)

What about payroll procedures?

Premium payments are considered “Supplemental Wages.”

IRS defines supplemental wages as compensation paid in addition to the employee's regular wages that includes, but is not limited to, severance or dismissal pay, vacation pay, back pay, bonuses, moving expenses, overtime, taxable fringe benefits and commissions.

26 CFR § 31.3402(g)-1

How are taxes withheld from a bonus?

1. Percentage Method (if off payroll cycle)

- A flat supplemental income tax withholding rate of **22%** applies to the bonus amount (37% if over \$1 million)
This is true regardless of the employee's actual income tax rate.
- FICA taxes (payroll taxes):
 - Social Security (OASDI) in the amount of **6.2%** applies to the employee (up to \$176,100 of compensation in 2025)
 - Medicare (HI) of **1.45%** applies to the employee (additional 0.9% if salary over \$200k/250k)
- State and Local taxes may also apply.
- Minimum illustrated bonus tax rate should be **29.65%** (= 22% + 6.2% + 1.45%)

2. Aggregate Method

- Bonus and Regular Pay are combined, and withholdings are based on the tables from the employee elections on their W-4, so could be higher or lower than 22%

See Publication 15 (2025), (Circular E), Employer's Tax Guide

Actual cost of a \$10,000 premium = bonus (single bonus)

Employee	\$10,000 Insurance Premium	Employer
\$ 10,000.00	Bonus	\$ 10,000.00
\$ (2,200.00)	Income Tax at 22%	
\$ (620.00)	FICA at 6.2%	\$ 620.00
\$ (145.00)	Medicare at 1.45%	\$ 145.00
\$ 7,035.00	Total	\$ 10,765.00
	Compensation Deduction at 32% of \$ 10,765.00	\$ (3,444.80)
	Net Employer Cost	\$ 7,320.20

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Employee out of pocket cost is
\$2,200 + \$620 + \$145 = \$2,965
assumes EE inc + FICA tax rate of 29.65%

If taken over 24 pay periods, each
paycheck is **lowered** by \$123.54

Gross up bonus (double bonus)

Premium

1 – EE's tax rate

=

Total bonus

\$10,000

1 – 0.30

=

Total bonus

\$10,000

0.7

=

Total bonus

\$14,286

=

Total bonus

Actual cost of a \$10,000 premium (double bonus; 29.65% tax rate)

Note: dollar amount on W-2 is higher

Again, due to withholding rules, assume EE Inc + FICA tax rate of **29.65%** (not 30%, as in our example)

Employee	\$10,000 Insurance Premium	Employer
<div>\$ 14,214.64</div>	Bonus	\$ 14,214.64
\$ (3,127.22)	Income Tax at 22%	
\$ (881.31)	FICA at 6.2%	\$ 881.31
\$ (206.11)	Medicare at 1.45%	\$ 206.11
\$ 10,000.00	Total	\$ 15,302.06
	Compensation Deduction at 32% of 15,302.06	\$ (4,896.66)
	Net Employer Cost	\$ 10,405.40

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\$10,000 Insurance Premium

Employer

\$ 14,214.64

Bonus

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\$ (3,127.22)

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\$ 10,000.00

Total

\$ 15,302.06

Compensation Deduction at
32% of 15,302.06

\$ (4,896.66)

Net Employer Cost

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Employee Taxes due: \$4,214.64

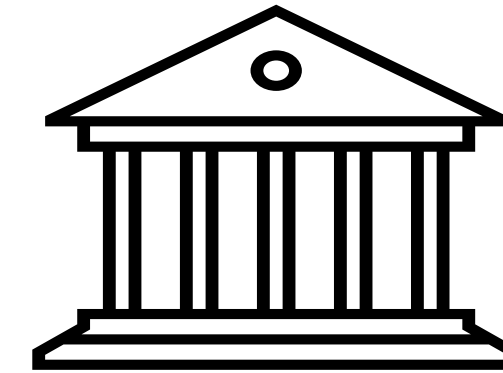
Taxes Withheld: \$4,214.64

Employee Net Outlay : \$ 0.00

What if ER doesn't want to pay more, and EE doesn't want smaller paycheck?

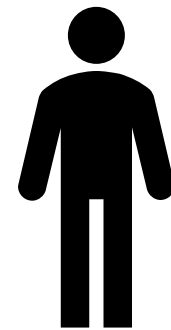
Business

**No more than
\$10,000**



Insurance
Company

**I don't want the
bonus to "hurt" me**



A

Insurance
Policy on
A

Result ... smaller premium

Actual cost of a \$10,000 bonus (net bonus; 29.65% tax rate)

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Note:
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premium !

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Note: smaller premium !

Employee Taxes due: \$2,965

Taxes Withheld: \$2,965

Employee Net Outlay: \$ 0

Hmmm, employee can quit at any time and walk away with policy.

What about some type of “restriction?”

Note:

- On the following slides, we describe arrangements that some might call a “REBA,” which stands for Restrictive Executive Bonus Agreement (or some similar phrase).
- Might be best to not rely on the label “REBA” and instead carefully read the provisions of your clients’ particular agreements.

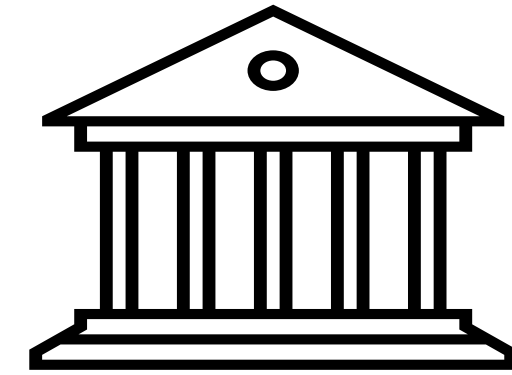
We'll look at 3 types of “restrictions”

- A. Employee needs owner's permission to access cash value unless and until employee works to a certain date
- B. If employment terminates before a certain date, the employer gets the policy “back”
- C. If employment terminates before a certain date, the employee owes money to the employer

A. Employee needs employer's ok to access cash value

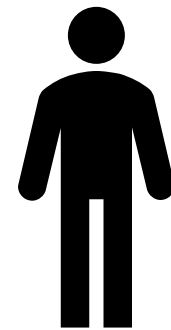
Business

maybe . . .



Insurance
Company

Please ?



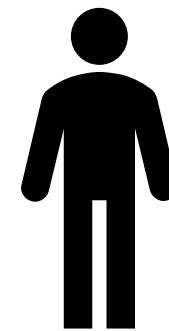
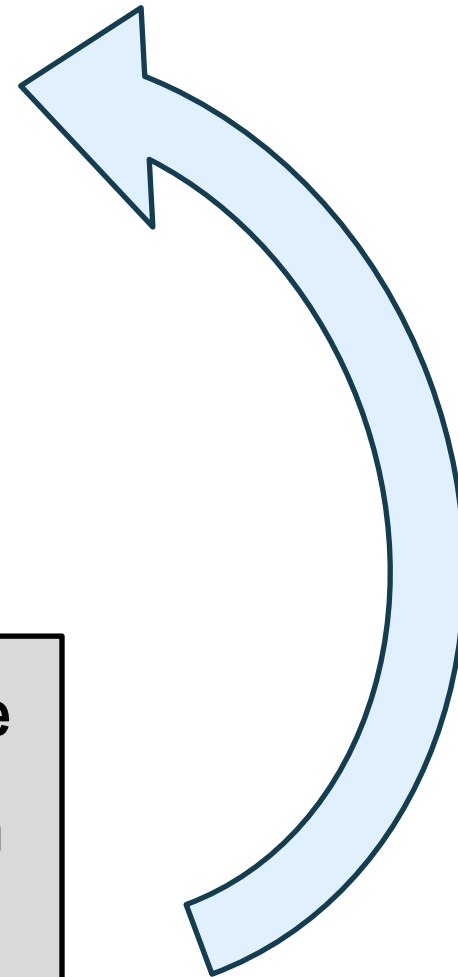
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Insurance
Policy on
A

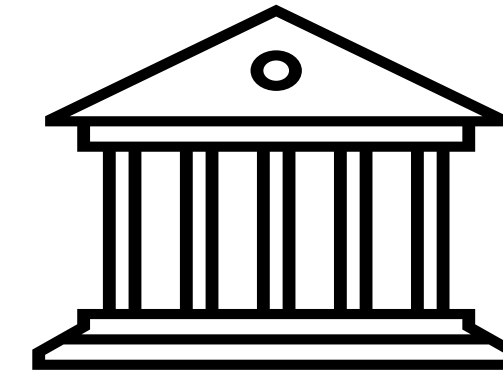
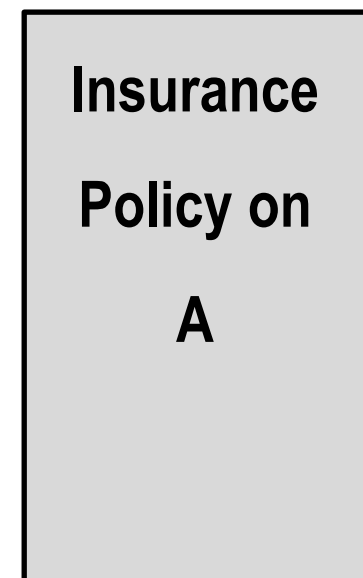
A. Restriction where employer can “veto” employee’s access

- Employer and employee enter into agreement that states:
 - The right of policyowner/employee to:
 - surrender the policy in full or partially
 - take a policy loan
 - collaterally assign policy as collateral security, or
 - change ownership of the policy,... may be exercised only with the consent of employer.
 - The restriction will be released if the employee stays working there a certain number of years (e.g., 6 years).
- Note: employer doesn’t get anything “back,” just can prevent employee from accessing cash.
- Insurance company paperwork puts the restriction in place (often labeled “restrictive endorsement agreement”)
 - Sometimes restriction stays in place (from insurance company perspective) indefinitely, unless and until formally released by employer in writing.
 - Other times restriction is designed to be released at a certain future date automatically.
 - What does your company do?
- Question: What if employee leaves “early?”

B. Stronger restriction - employer can take policy “back”



A



Insurance Company

B. Stronger restriction where employer gets policy “back”

- Employer and employee enter into agreement that states:
 - The right of policyowner/employee to:
 - surrender the policy in full or partially
 - take a policy loan
 - collaterally assign policy as collateral security, or
 - change ownership of the policy,... may be exercised only with the consent of employer.
 - **But also states that, if the employee leaves “early,” the employer gets the policy back.**
- Would employer ensure ability to get policy back by having a collateral assignment on the policy?
- What’s tax effect?
 - Per IRC § 83(a), seems that employer does not get deduction – and employee does not get income taxed – until this type of restriction is terminated, which occurs when employee vests (i.e., property no longer subject to substantial risk of forfeiture).
 - Per Treas. Reg. 1.83-1(a)(1), the employer is considered owner of the property until it is vested.
 - Or, seems employee could do “83(b)” election, being taxed on premium despite not being vested yet in policy.
- Should they instead just do employer-owned policy with split dollar endorsement (and separately promise to transfer policy in year of vesting)? Consistent with Treas. Reg. 1.83-1(a)(2).

- Again, per Treasury Regulation § 1.83-1(a)(1), the employer is considered owner of the property until it is vested.
- Seems that, upon vesting, the parties are **taxed just as if** employer actually owned the policy, and transferred it to the employee upon the vest date.
- Raises the question:

How is the transfer of a policy from employer to employee taxed anyway?

Treasury Regulation § 1.83-6 Deduction by employer.

(a) *Allowance of deduction—*

- (1) **General rule.** In the case of a transfer of property in connection with the performance of services, or a compensatory cancellation of a nonlapse restriction described in section 83(d) and § 1.83-5, a deduction is allowable under section 162 or 212 to the person for whom the services were performed. **The amount of the deduction is equal to the amount included as compensation in the gross income of the service provider under section 83 (a), (b), or (d)(2),** but only to the extent the amount meets the requirements of section 162 or 212 and the regulations thereunder.

...

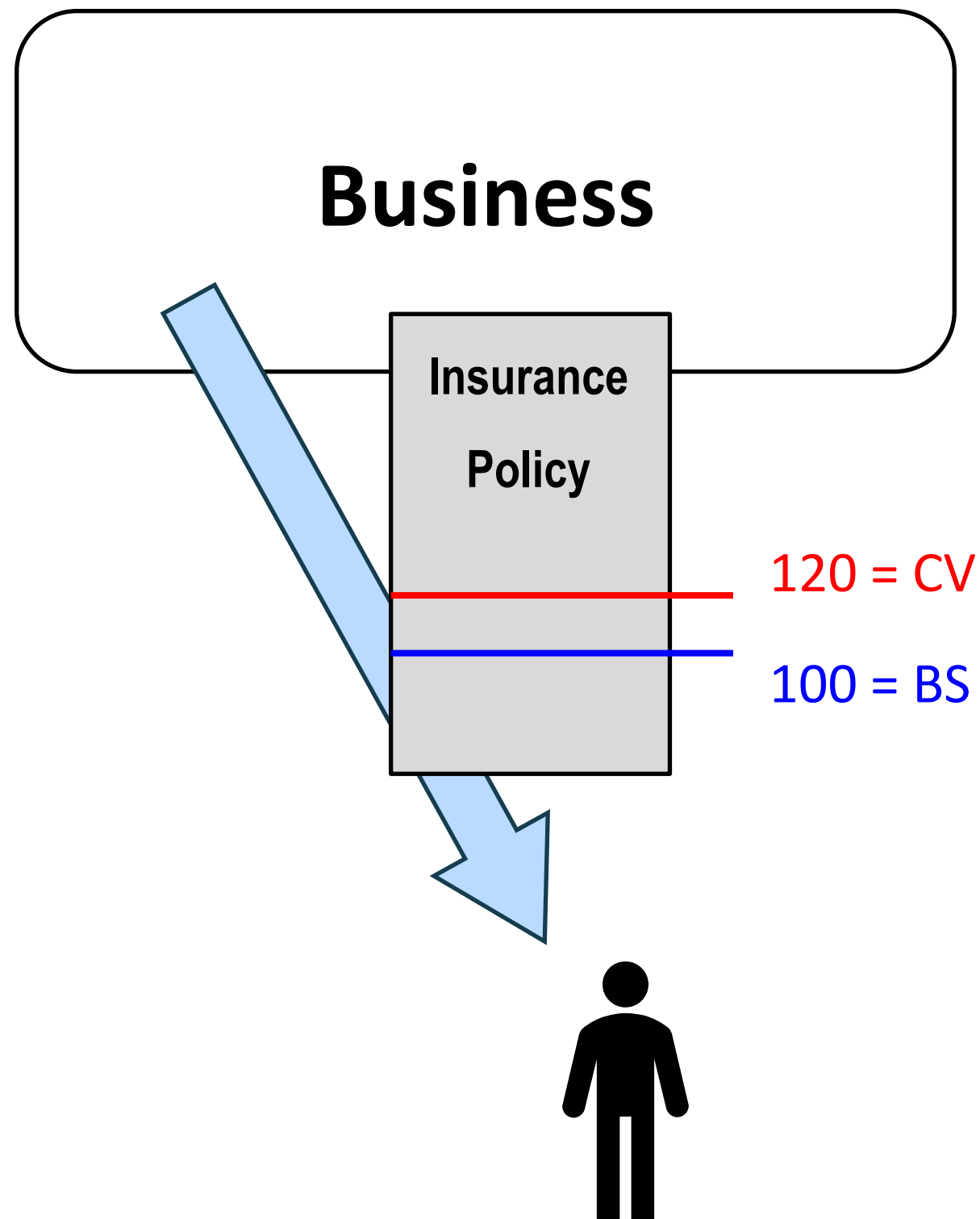
(5) **Transfer of life insurance contract (or an undivided interest therein)—**

- (i) **General rule.** In the case of a **transfer of a life insurance contract** (or an undivided interest therein) described in § 1.61-22(c)(3) in connection with the performance of services, a deduction is allowable under paragraph (a)(1) of this section to the person for whom the services were performed. **The amount of the deduction, if allowable, is equal to the sum of the amount included as compensation** in the gross income of the service provider under § 1.61-22(g)(1) and the amount determined under § 1.61-22(g)(1)(ii).

(b) **Recognition of gain or loss.** Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, **gain or loss is recognized** to the extent of the difference between

- (1) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and
- (2) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence.

Transferring policy with **built-in gain**



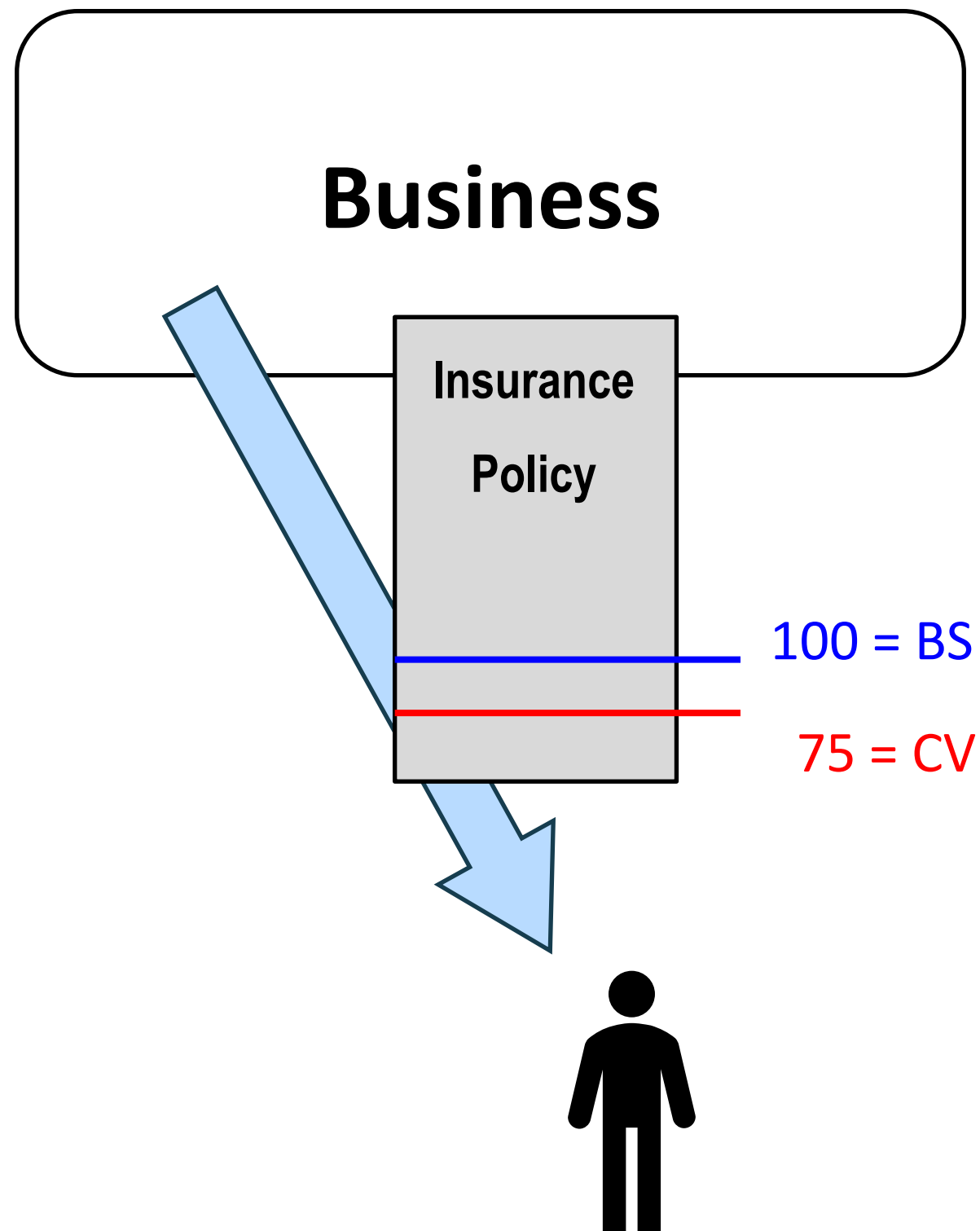
If gain in policy (assume CV = FMV):

Employee's income = value of policy = **120**

Employer's net deduction = basis in policy = **100**

- Deduct value of policy = 120
- Tax on built-in gain = 20

Transferring policy with **built-in loss (underwater)**



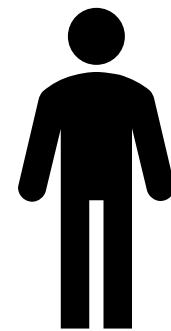
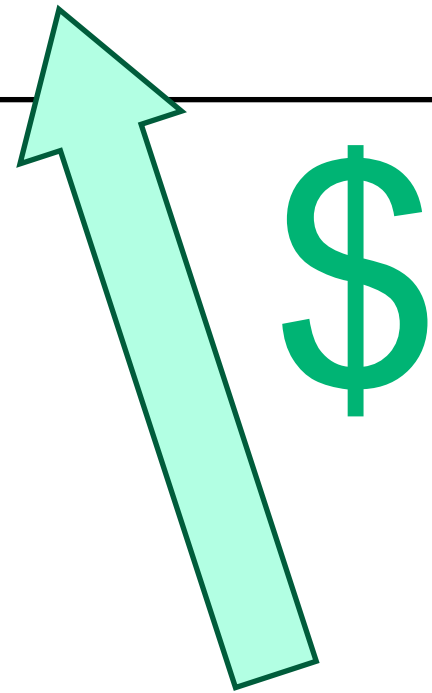
If policy underwater (assume CV = FMV):

Employee's income = value of policy = **75**

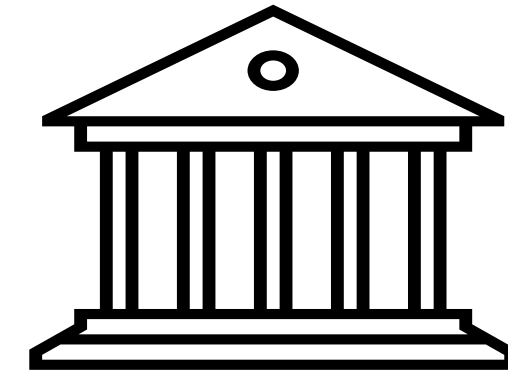
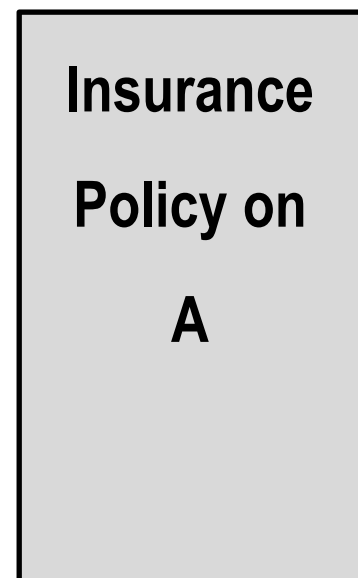
Employer's deduction = ?

- Basis = 100 ?
- CV = 75 ?

C. One more “restriction” - employee pays money to employer



A



Insurance Company

C. What if employee owes money to employer if leaves “early?”

- Employer and employee agree that if employee leaves “early,” then employee owes money to employer.
 - the employer does not have a right to obtain the policy.
 - perhaps evidenced in a separate employment agreement.
 - pay to employer a dollar amount, less the taxes employee had paid?
- Until the magic date is reached, employer and employee could agree to either:
 - restricted, i.e, employee access to cash value is subject to employer’s consent, or
 - unrestricted, i.e., employee has full access to policy and its cash value.
- How is it taxed? Cases supporting treatment of premiums as currently deductible (and currently taxable) like a typical unrestricted bonus plan:
 - *Winter v. Comm’r*, TC Memo 2010-287 (2010)
 - *Beaver v. Comm’r*, 55 TC 85 (1970)

Q: If a restriction on bonus plan terminates close to “retirement age,” does that mean it might be characterized as an ERISA pension plan rather than as an ERISA welfare benefit plan?

Remember, ERISA § 3(2) (29 U.S. Code § 1002) defines pension plan as any plan, fund, or program maintained by an employer that:

- provides retirement income to employees, or
- results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.

If is ERISA pension plan, could be bad news, as pension plans escape most ERISA requirements only if:

- primarily for select management and highly paid, and
- unfunded.

If employee owns policy, does not seem “unfunded.” All ERISA requirements might then apply.

Presumably is a bigger danger with a strong “section 83” restriction, where employer can get policy “back.”

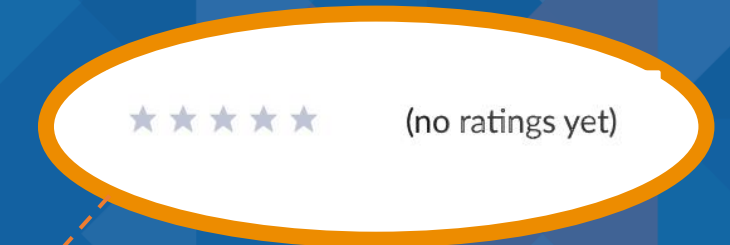
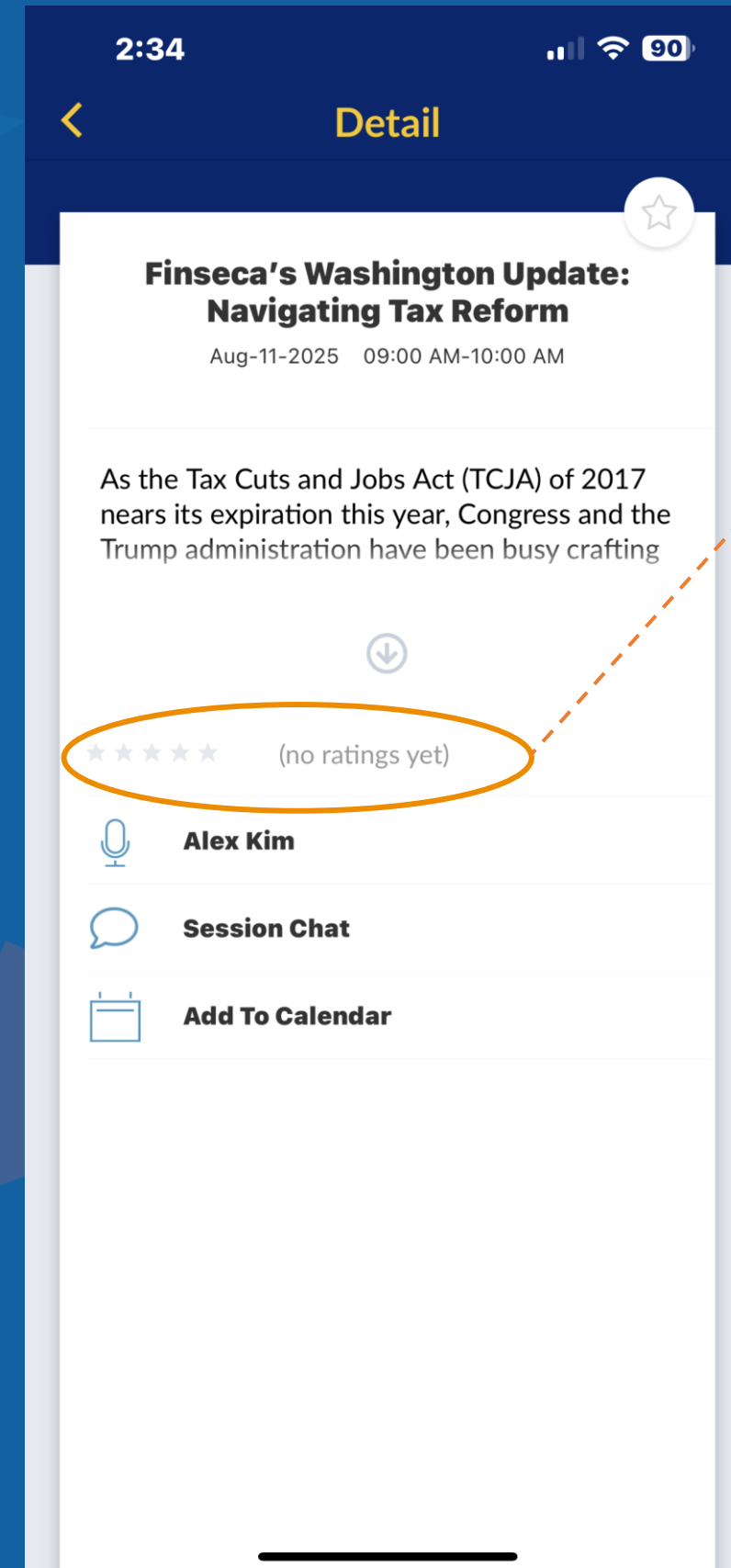
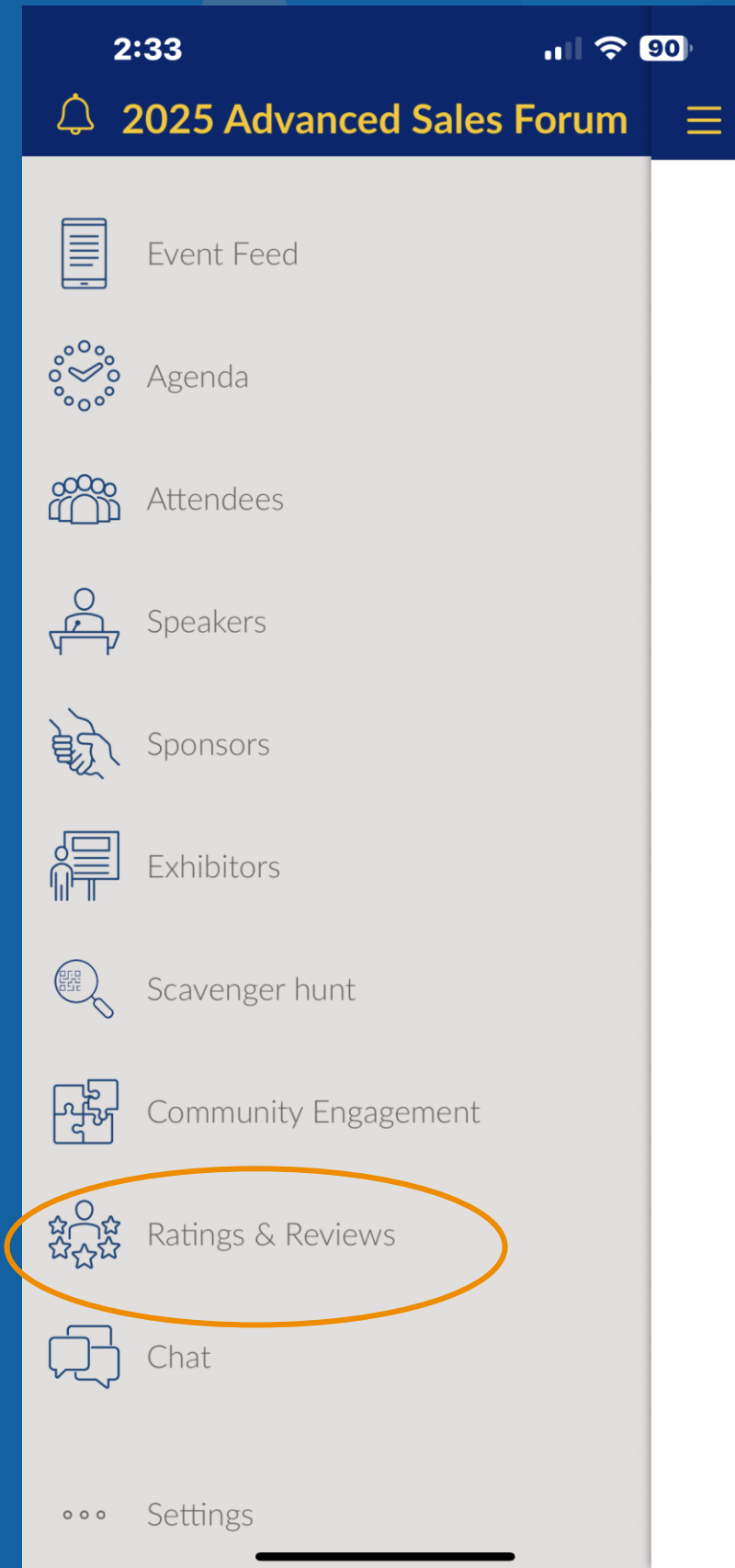
When all is considered ...

Life insurance bonus plans:

- make employees happy by providing them (and their families) a valuable benefit
- make employers happy by providing an immediate deduction
- are relatively easy to administer

“get yours today!”

Please Provide Your Feedback on the Conference App



Thank You

