Executive bonus plans with asset-based long term care

Client profile

Profitable C Corporations looking to reward key employees or shareholder-employees.

Conversation starters

- Can I show you how a business owner of a C corporation may qualify for a tax deduction leveraging a linked benefit product with a long term care (LTC) rider?[1]
- Did you know you can use asset-based LTC solutions for a § 162 executive bonus arrangement?

Client need

C corporations with shareholder-employees and/or key employees may be concerned about the future risks and costs associated with an LTC event. High net worth clients may have the assets to "self-insure" the risk of needing LTC but would like to use business dollars in a tax-efficient manner to protect against the risk.

The income tax rate for C corporations was reduced from 35% to 21% beginning in 2018. However, since there is no guarantee these rates will stay low over the long term, now may be a good time for corporations with extra cash on hand to reward employee-shareholders and/or key employees with employer-funded benefits.

Opportunities

Asset-based LTC solutions provide clients with a death benefit, LTC protection, and the potential for cash value growth or a return of premium should the owner of the policy ever surrender the contract. Business owners can use corporate assets to protect themselves against the future costs of an unexpected LTC event while getting both the advantages of a life insurance policy and some of the tax advantages of standalone LTC insurance.[2]

- **Executive bonus plan:** Also known as a § 162 plan, it typically allows employers to fund a life insurance policy for highly compensated employees as a form of bonus compensation that is tax-deductible for the business. The employer-paid "bonus" is paid directly to the insurance company. Usually premiums are scheduled for a certain number of years, but single-pay and lifetime-pay policies may also be used. Although the employee must report the life insurance premiums as taxable compensation, LTC acceleration, extension, and inflation riders on some life insurance policies are filed as separate LTC contracts. This means that premiums paid by the employer for these riders are not taxable income to C corporation employee-shareholders,[3] employees, or spouses. Some riders may even offer lifetime benefits, should the client need LTC support for a prolonged period of time.

- **Restricted bonus arrangement:** Some employers wish to create longevity incentives for their top employees ("golden handcuffs") using their § 162 plans. A restricted bonus arrangement may limit the employee's rights with respect to their § 162 insurance policies until specified vesting conditions are met and/or require repayment of premiums if the employee leaves prematurely.[4]

High net worth clients are using asset-based LTC solutions today as an alternative to self-insuring the risk of a catastrophic LTC event. These products can offer the value of a guaranteed return of premium, LTC leverage, and a death benefit should the client pass away and not need LTC support. This value proposition, coupled with a potential tax deduction, makes asset-based LTC solutions a popular option for employee-owners and executive bonus plans.

Case study

Background

A family-owned business is organized as a C corporation. The father who founded it passed away after needing residential long term care. Some of the corporation was then sold to unrelated buyers, causing a capital influx for the business. The children who retained partial ownership and still work for the business wanted to put this cash to tax-efficient use, especially to provide for their own LTC needs. These children are in their late 50s through late 60s, with four being married and two being single.

Results

A financial professional working with family members suggested an executive bonus plan for the class of owner-employees, funded with hybrid life and LTC products. The married employees applied for hybrid policies jointly covering them with their spouses. Each policy was personally owned.

Each life hybrid policy would provide a $7500 monthly benefit for LTC for six years. The policies also provide a death benefit and a guaranteed return of premium. The total premium for the ten policies amounted to over $1 million (single premium), a little over a third of which was both deductible to the corporation and not includable in income for the insured individuals. The entire premium is deductible to the corporation, but the portion of the premium not for LTC is treated as taxable compensation to the participating employees.

Though part of the premium payment is taxable to the employees, they also have access to the cash value of these policies in exchange. Products can be designed to make sure cash values equal to the taxable premium are accessible within the early years of the policy.

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[1] Clients must consult their own tax advisors to determine eligibility for a tax deduction.
[2] An employer-sponsored plan that provides coverage under a qualified LTCi contract may be treated as an accident and health plan. IRC § 7702B(a)(3). In general, IRC § 106(a) and Reg. §1.106-1 provide that gross income of an employee does not include employer provided coverage under an accident and health plan covering the employee, the employee's spouse and the employee's dependents. There is apparently no limit on the amount of this exclusion. Under IRC § 105(b), an employee may exclude amounts received through employer-provided coverage paid to reimburse expenses incurred by the employee for long term care of the employee, the employee's spouse, or the employee's dependents. Amounts excluded from gross income under IRC § 105(b) or IRC § 106(a) are also excluded from income tax withholding under IRC § 3401.
[3] If the plan provides benefits for owner-employees primarily because of their ownership interest, then the exclusions under IRC § 105(b) and IRC § 106 are not available. Therefore, it must be shown that such benefits are being provided to the individual 1) in his/her capacity as an employee of the business; and 2) whether there is any rational basis other than ownership to differentiate that individual from other employees.
[4] We offer no opinion on the timing of the recognition of income under a restricted arrangement.

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