SAMPLE DOCUMENT

SECTION 162 EXECUTIVE BONUS PLAN (INCLUDING OPTIONAL PROVISIONS FOR RESTRICTED 162 BONUS PLAN)

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Background Information:

- *This sample document is a life insurance bonus plan, under which an employer provides additional compensation to an executive/employee for services. It is designed so that the employer pays the premiums for a life insurance policy owned by the executive (who usually is also the insured). While the employee will typically be the direct owner of the policy, it could also be owned by an irrevocable life insurance trust or other third-party—though there may be gift tax consequences to the employee from the employer's payment of the premiums in this circumstance.*
- *It is labeled a "Section 162" bonus plan because the employer takes a current deduction (under I.R.C. § 162) for the premium amount as it is paid. This is in contrast to a "Section 83" bonus plan – not contained in the following document – which involves an unvested life insurance policy (i.e., one subject to a substantial risk of forfeiture). With such a plan, I.R.C. § 83 generally provides that the premium amounts are not deductible (nor taxable to the executive) when paid, but instead the value of the policy is deducted and taxed when the policy is vested in the executive.*
- *A life insurance bonus plan generally must be put in writing. While it is always a good idea to put agreements in writing to ensure that the parties fully understand their respective rights and obligations, a life insurance bonus plan is generally deemed to be a welfare benefit plan under ERISA, which normally requires that welfare benefit plans be in writing.*
- *The following document gives the drafter the flexibility to choose between (i) a Traditional (Unrestricted) 162 Bonus Plan or (ii) a Restricted 162 Bonus Plan, per paragraphs 2(a) and (b).*
  - (i) *Traditional (Unrestricted) 162 Bonus Plan – In this plan, the employer pays the premium on a policy that the executive owns, free of any restrictions. Generally, the employer is allowed a deduction for the payment of the premium as it is paid (if the amount is reasonable compensation), and the executive simultaneously recognizes this payment as compensation income. See I.R.C. §§ 61, 162; and Treas. Reg. § 1.61-2(d)(2)(ii)(A).*
  - (ii) *Restricted 162 Bonus Plan – In this plan, the employer pays the premium on a policy that the executive owns, but the policy is subject to a restriction that prevents the executive from, among other things, accessing the policy's cash value for a specified period of time (e.g., five years)*

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without the employer's consent. So that the insurance company will help enforce this restriction, the employer and executive execute a restrictive endorsement (generally labeled a "Modification of Ownership Rights" at Northwestern Mutual) that accompanies the policy on the insurance company's records. The restriction is removed if and when the executive satisfies the condition to remove the restriction, generally being continued employment for the specified time period. If the restriction is not removed (perhaps due to the executive quitting before the specified time period passes), the executive nonetheless keeps the policy, and even if the restriction remains, the executive generally has the right to convert the policy to paid up insurance. In no event does the employer have a right to the policy or its benefits (e.g., does not "get the policy back" if the executive leaves early). The policy is solely owned by and vested with the executive from the inception of the arrangement, and this is why each premium payment is deductible for the employer and currently income taxable to the executive (just as with a Traditional (Unrestricted) 162 Bonus Plan).

- *The employer can "gross up" the bonus to the executive (optional paragraph 4) to cover the additional taxes the executive will owe as a result of the premium payment.*
- *For further information regarding these plans, refer to the Northwestern Mutual special study entitled "ERISA and Nonqualified Employee Benefit Plans" (F.O. 22-3901).*

SECTION 162 EXECUTIVE BONUS PLAN

(including optional provisions for Restricted 162 Bonus Plan)

[<u>*Name of Employer's Business*</u>**]**, a **[**<u>*Name of State*</u>**]** **[**<u>*Form of Entity*</u>**]** (the "Employer"), and **[**<u>*Name of Executive Employee*</u>**]** (the "Executive") hereby enter into this Section 162 Executive Bonus Plan (Agreement), and agree as follows:

1. Executive is eligible to participate in this bonus plan because Executive is a highly valued employee of Employer. Nothing in this Agreement shall be construed as altering **[**the at-will nature of Executive's employment**]** **[**the term and termination provisions of that certain **[**<u>*Title of Employment Agreement*</u>**]** dated as of **[**<u>*Date*</u>**]** by and between the Employer and the Executive**]**.

2. As additional compensation to Executive, the Employer agrees to pay all premiums on life insurance Policy No. **[______________________________]** insuring Executive's life issued by The Northwestern Mutual Life Insurance Company, Milwaukee, Wisconsin (Insurer), and owned by Executive (the "Policy"), as long as Executive remains employed by the Employer. No employee contributions are required.

   <u>Comment:</u> *While the Executive employee will typically be the direct owner of the policy, it could also be owned by an irrevocable life insurance trust or other third-party—though there may be gift tax consequences to the Executive employee from the Employer's payment of the premiums in this circumstance.*

<u>Comment:</u> *If a "Restricted" 162 Bonus Plan is desired—that is to say, one in which the Executive employee's ability to access the policy value is to be restricted until some future date—insert paragraphs 2(a) and 2(b), immediately below. If not, skip to paragraph 3. To put the "restriction" of paragraphs 2(a) and 2(b) into effect, the parties execute a restrictive endorsement (oftentimes labeled a "Modification of Ownership Rights") that accompanies the policy on the insurance company's records.*

a. The Executive will execute an endorsement on the Policy restricting the Executive's right to do any of the following without the consent of the Employer: (i) withdraw or access the Policy's cash value in any manner, whether by partial or complete surrender of the Policy, surrender of additions, taking dividends in cash, or otherwise, (ii) obtain a policy loan from the insurance company, (iii) pledge or assign the Policy as collateral, (iv) change the ownership of the policy or any interest in it, or (v) change insured. However, the Employer shall not be entitled to receive any benefits under the policy.

b. Employer shall release the restrictive endorsement after **[____]** years have passed beyond the date this Agreement is entered into, if Executive remains continuously employed by Employer throughout that time. If Executive's employment terminates for any reason before that time period has passed, Employer is under no obligation to release the endorsement. However, if Executive's employment terminates prior to that time period has passed, the Executive has the right to retain ownership of the policy, and has the right to convert it to a plan of paid up insurance.

3. The Executive will recognize the premium amounts paid by Employer hereunder as additional compensation for all applicable federal and state tax purposes.

4. **[Optional "Gross-Up" Provision]** Employer shall, in addition to the premium payment, annually increase the Executive's cash compensation by an amount determined by the following formula: **[P ÷ (1 – x)] – P]**; where "P" equals the premium on the Policy payable by Employer pursuant to this Agreement and "x" equals the Executive's marginal federal income tax bracket for such year. For example, if the annual premium on the Policy is $1,200 and the Executive's marginal federal income tax bracket is 36%, then the additional cash compensation payable hereunder shall be $675.00 (*viz.* ($1,200 ÷ (1 – 0.36)) – $1,200).

5. This Agreement is being delivered and is intended to be performed in **[**<u>*Name of State*</u>**]** and shall be construed and enforced in accordance with the laws of **[**<u>*Name of State*</u>**]**.

6. This Agreement embodies the entire understanding and agreement among the parties concerning the subject matter hereof and supersedes any and all prior written or oral negotiations, understandings, or agreements in regard thereto.

7. This Agreement may not be amended, altered or revoked except by an instrument in writing signed by all the parties hereto. Any such amendment, alteration or revocation shall be effective when so signed, or as of such other effective date as is designated therein.

8. This Agreement may be executed in two (2) or more counterparts, each of which shall be deemed an original and all of which together shall constitute one and the same instrument, or with multiple signature pages which may be delivered electronically.

9. Special ERISA Provisions – The following provisions are part of this Agreement and are intended to meet the requirements of the Employee Retirement Income Security Act of 1974:

    a. The Named Fiduciary and Claims Manager: **[**<u>a representative of the Employer, e.g., The Secretary of the Employer</u>**]**.

    b. The funding policy under this Plan is that all premiums on the Policy shall be remitted to the Insurer by the Employer when due.

    c. Direct payment by the Insurer is the basis of payment of benefits under this Plan, with those benefits in turn being based on the payment of premiums as provided in the Plan.

    d. Claims procedure – for a claim other than a death benefit:

        i. If for any reason a claim for benefits (other than a death benefit) under this Plan is denied by the Employer, the Claims Manager shall deliver to the Claimant a written explanation setting forth the specific reasons for the adverse benefit determination; specific references to the Plan section on which the adverse benefit determination is based; a description of any additional material or information necessary for the Claimant to perfect the claim and an explanation of why such material or information is necessary; and a description of the Plan's review procedure including a statement of the Claimant's rights to bring a civil action under Section 502 of ERISA following an adverse determination on review, all written in a manner calculated to be understood by the Claimant. For this purpose:

            (A) The Claimant's claim shall be deemed filed when presented orally or in writing to the Claims Manager.

            (B) The Claims Manager's explanation shall be in writing and delivered to the Claimant within 90 days of the date the claim is filed unless the Claims Manager determines that special circumstances require an extension of time for processing the claim. If such an extension of time for processing is required, written notice of the extension shall be furnished to the Claimant prior to the termination of the initial 90-day period. In no event shall such extension exceed a period of 90 days from the end of such initial period. The extension notice shall indicate the special circumstances requiring an extension of time and the date by which the Claims Manager expects to render the benefit determination. If the period of time is extended because the Claimant has failed to provide necessary information to decide the claim, the period for making the benefit determination shall be tolled from the date on which the notification of the extension is sent to the Claimant, until the date on which the Claimant provides the information. Failure to provide notice of decision in the time specified is the same as denial of the claim and the Claimant is entitled to require a review of the denial under the review procedures.

ii. The Claimant (or his or her duly authorized representative) shall have 60 days following the receipt of the denial of the claim to file with the Claims Manager a written request for review of the denial. For such review, Claimant shall have the opportunity to submit written comments, documents, records, and other information relating to the claim for benefits. Claimant shall be provided, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the claim for benefits. The review of the claim shall take into account all comments, documents, records, and other information submitted by the Claimant relating to the claim, without regard to whether such information was submitted or considered in the initial benefit determination.

iii. In the case of a request for review of an adverse benefit determination, the Claims Manager is designated as the appropriately Named Fiduciary for a full and fair review. On review, the Claims Manager shall notify the Claimant not later than 60 days after the Company's receipt of the request for review, unless the Claims Manager determines that special circumstances require an extension of time for processing the claim, in which case a decision shall be rendered as soon as possible, but not later than 120 days after receipt of the request for review. If such an extension of time for review is required because of special circumstances, written notice of the extension shall be furnished to the Claimant prior to the termination of the initial 60-day period. In no event shall any such extension exceed a period of 60 days from the end of the initial period. The extension notice shall indicate the special circumstances requiring an extension of time and the date by which the Plan expects to render the determination on review. If the period of time is extended because the Claimant has failed to provide necessary information to decide the claim, the period for making the benefit determination shall be tolled from the date on which the notification of the extension is sent to the Claimant, until the date on which the Claimant provides the information. The decision on review shall be in writing and in the case of an adverse benefit determination shall include: (i) the specific reason or reasons for the decision; (ii) references to the specific Plan provisions on which the benefit determination is based; (iii) a statement that the Claimant is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records and other information relevant to the Claimant's claim for benefits; and (iv) a statement of the Claimant's right to bring an action under Section 502(a) of ERISA, all written in a manner calculated to be understood by the Claimant. If the decision on review is not furnished within such time, the claim shall be deemed denied on review.

e. Claims procedure – for a claim for a death benefit:

A claim for a death benefit must follow the procedures established by the Insurer which may include time deadlines. If a participant's beneficiary makes a written request to the Claims Manager, the Claims Manager will either provide copies of forms or instructions required by Insurer to make a claim or tell the participant's beneficiary how to obtain them. Insurer will notify the beneficiary if the claim is denied and will explain the procedures it has for reviewing any claims which it denies. The time and manner of such review, and the time for a final decision shall correspond to the time and manner of review for claims denied by the Claims Manager. The beneficiary must act in making any claim for a death benefit.

IN WITNESS WHEREOF, the Parties have executed this Agreement this _____ day of _______________, 20___.

[*NAME OF EMPLOYER*]

By: ____

Its: ____

Attest:_____________________________________

Its: ____

[*NAME OF EMPLOYEE*]

____

SSN:_______________________________________

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