MOREHEAD
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RESTRICTED EXECUTIVE BONUS ARRANGEMENT

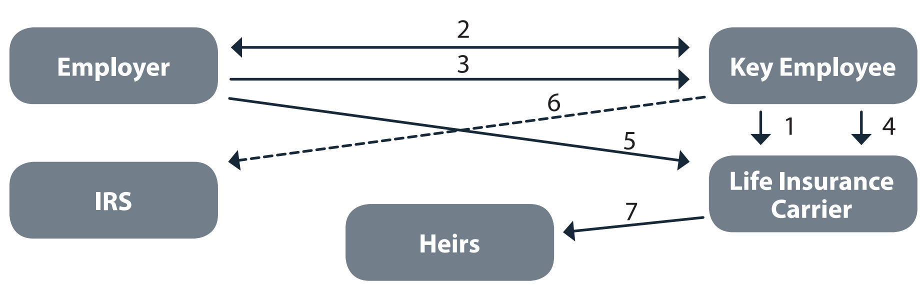
In today's increasingly competitive business environment, finding a cost-effective way to reward key employees can be challenging. Qualified plans have preferential tax treatment, but they have strict administration requirements. They must include all employees and reward them to the same degree, regardless of the benefit those employees bring to the business. Nonqualified Salary Deferral Plans and Supplemental Executive Retirement Plans (SERPs) allow a business owner to reward key employees in a discriminatory fashion, but they still require plan documents and ongoing administration, as well as meeting the requirements of Section 409A of the tax code. A Restricted Executive Bonus Arrangement (REBA), on the other hand, may be a more attractive option for rewarding a business's most productive employees in a way that is flexible, cost effective and simple to administer.

WHAT IS A REBA?

A REBA is a nonqualified benefits program to recruit, reward and retain key talent. The employer pays all or part of the premium on a life insurance policy for a key employee under a "bonus" arrangement. 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. A restricted endorsement limits the employee's access to the policy until the employer releases the endorsement, providing a "golden handcuff" that ties the key employee to the company.

A REBA can provide significant death benefits and tax-advantaged cash value accumulation for key employees, allowing them to meet personal financial goals.

HOW DOES IT WORK?



1. Key employee applies for a life insurance policy on his/her life.
2. Employer and key employee enter into a formal REBA agreement, which provides certain restrictions — for example, the employer may require the employee to repay bonuses if employment is terminated before he/she is vested in the bonuses. Employer and the key employee execute a "restrictive endorsement" on the policy with the life insurance company, limiting the employee's policy rights to the right to change the beneficiary.
3. Employer bonuses an amount equal to the premium to the key employee.
4. Key employee pays the premium to the life insurance company.
5. Once the key employee is vested under the terms of the REBA, the endorsement is lifted and the employee may access the potential cash value in any way desired, including supplementing retirement income through policy loans and withdrawals.
6. As the employee vests in the policy, he/she recognizes income equal to vested premiums paid and the employer gets a compensation deduction for the same amount under IRC §162.
7. At the employee's death, the life insurance death benefit proceeds may be paid to his/her heirs income tax-free.*

BENEFITS TO KEY EMPLOYEE

- Employee owns a "portable" life insurance policy.
- Employer can "double bonus" employee to offset any tax liability.
- Policy cash value grows on a tax-deferred basis and can be accessed after the endorsement is removed to supplement retirement or other income needs.
- The death benefit provides an income tax-free pre-retirement survivor's benefit.

BENEFITS TO EMPLOYER

- Provides a program to recruit, reward and retain key talent.
- Freedom to select participants.
- Bonuses are tax-deductible, as long as the employee's total compensation package is "reasonable."
- No impact on existing plans.
- IRS approval not required; avoids most of the cost and administrative requirements associated with establishing a qualified plan under ERISA.
- REBAs can be less expensive to set up and administer than nonqualified deferred compensation plans.
- A restricted endorsement limits the employee's access to the policy until the employer releases the endorsement. This ties the key employee to the company.
- Provides an attractive executive benefit program for a pass-through business entity where executive deferrals would be taxable to the business owners or for a not-for-profit company where deferral plans are limited under I.R.C. § 457.

CONSIDERATIONS FOR THE EMPLOYEE

- The key employee must recognize the vested bonus payments as taxable income under IRC § 61 and must pay Social Security (FICA) and federal unemployment (FUTA) taxes on the vested bonus amounts.
- Unless additional planning is done, the death benefit of the life insurance policy will be included in the key employee's estate.
- If the key employee doesn't meet the requirements of the vesting schedule, he or she may not be able to access the life insurance policy's cash value.

CONSIDERATIONS FOR THE EMPLOYER

- The employer may not recapture the bonuses given to the key employee, even if the employee doesn't meet the requirements of the vesting schedule.
- The employer bonuses should be discretionary. Any understanding to pay bonuses, either contractual or implied, could subject the arrangement to IRC § 409A, as a deferred compensation plan.

THE BOTTOM LINE

A REBA is an attractive option for rewarding a business's most productive employees in a way that's flexible, cost effective and simple to administer. A REBA can provide significant death benefits and tax-advantaged cash value accumulation for key employees, allowing them to meet personal financial goals.

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