Executive Bonus (Section 162) Plans
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What is it?

A bonus is an addition to regular salary or compensation that enables employees to share in profits resulting from a successful year. Bonuses are often used for executives as an incentive-oriented form of compensation, based on the attainment of profit or other goals during the year. Bonuses are sometimes used to assist executives in funding their share of the premium to a split dollar life insurance plan.

Example(s): XYZ Corporation expected each of its sales executives to bring in $100,000 worth of new business in Year 1. Any executive exceeding this goal in Year 1 would be given a bonus on January 1 of Year 2 in an amount equal to 10 percent of his or her new business in excess of $100,000. Because Joe brought in an extra $50,000 worth of business, he received a $5,000 bonus check on January 1, Year 2.

When can it be used?

Employers can use bonus plans whenever they want to attract, motivate, and retain key employees. These plans can be informal or even oral. There are no tax or other legal requirements for a written plan or for filing anything with the government. However, a written plan is often desirable. First, a written plan helps to avoid disallowance of the corporation's deduction on the grounds that the bonus was unreasonable. Without a written plan, the Internal Revenue Service (IRS) is likely to conclude that a bonus is simply an excessive discretionary payment. And if this payment is made to a shareholder, the IRS may recharacterize it as a dividend instead of deductible compensation. A second reason for a written agreement is that it defines the terms of the bonus plan and assures the employee of legal grounds to require the corporation to live up to the agreement. For this reason, the terms of the agreement should be clearly defined.

Tip: Other forms of deferred compensation with many of the same incentive features as cash bonus plans exist. In particular, you may wish to consider incentive stock options.

Strengths

Helps business to attract, motivate, and retain key employees

A principal challenge to employers is to attract, motivate, and retain key employees (and executives in particular). These goals can be promoted by providing executive bonus plans to key employees. Receiving a lump sum of cash in-hand for quality work can serve as a significant motivational tool for many people. In addition, it can help to make one firm more attractive than another firm that offers the same salary.

Promotes increased productivity

Bonuses represent an incentive-based form of compensation that is very effective because of the close connection between performance and receipt of the reward. Bonuses can be used for a number of purposes, such as assisting an executive in the purchase of a life insurance policy.

Tied to company performance

Bonuses allow flexibility in compensation to reflect company performance. Thus, both the employer and the employee can reap the benefits of outstanding performance.

Plan is flexible and easy to design

Bonus plans are flexible and easy to design (within certain tax restraints). This is because bonus plans need not be written and need not be filed with the government.
Employee’s income tax can be deferred to next year

Because employees use the cash method (rather than the accrual method) of accounting, a bonus earned in one year does not have to be included in taxable income until it is received, usually in the following year.

You can also allow your employees to defer the receipt of a bonus until some later date. However, to avoid adverse tax consequences, make sure your bonus arrangement satisfies the requirements of IRC Section 409A if applicable.

Tradeoffs

Deductibility limited to "reasonableness"

Bonuses are limited by the requirement of "reasonableness" for the deductibility of compensation payments by the employer. More specifically, Section 162 of the Internal Revenue Code states that only reasonable allowances for salaries or other forms of compensation (which includes bonuses) will qualify for trade or business expense deductions.

Caution: In the case of publicly held corporations, no deduction will be allowed if compensation to particular employees exceeds $1 million in a given year.

How to do it

Consult with an attorney and an accountant to set up the plan

It is important that proper tax rules are understood and followed. An attorney will consider the goals of your business and your financial situation, and advise you of the most advantageous compensation plan to adopt. In addition, it may be necessary to consult with a certified public accountant to ensure that proper accounting methods are followed.

Tax considerations

Income Tax

To the employer

Bonuses are generally deductible by an employer according to the same rules as other forms of cash compensation. A bonus cannot be deducted unless it constitutes a reasonable allowance for services actually rendered. Also, note that no deduction is allowed for compensation in excess of $1 million paid to certain top executives.

Since bonuses are often payable after the end of the year in which they were earned, the "2½ Safe Harbor Rule" is important for bonus planning. Under this rule, an accrual method corporation can deduct a compensation payment that is properly accrued before the end of a given year, as long as the payment is made no later than 2½ months after the end of the corporation's tax year. Note, however, that the 2½ Rule does not apply to payments made to employees who own or control 50 percent or more of the corporation. For those employees, the corporation must pay the bonus during its taxable year to deduct it during that taxable year.

To the employee

A bonus is taxed to the employee as ordinary taxable income. Since employees file taxes according to the cash method (rather than the accrual method), the bonus is taxable to the employee when it is received.
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