An **Educational Guide**
for Clients and their Advisors

Attract. Retain. Succeed.

Executive Bonus Plans funded with whole life insurance

Business Planning Strategies

MassMutual
FINANCIAL GROUP®

We'll help you get there.®

The success of a business is often attributable to the efforts and abilities of a select group of key employees or executives. That is why it is essential for businesses to attract and retain talented, hard-working individuals who can help them prosper and grow.

Contents

The decision to purchase life insurance should be based on long-term financial goals and the need for a death benefit. Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, you should know that there may be little to no cash value available for loans in the policy's early years.

The information in this brochure is not written or intended as specific tax or legal advice and may not be relied on for purposes of avoiding any federal tax penalties. MassMutual, its employees and representatives are not authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel.

Addressing the needs of businesses and their executives

Attracting and keeping the best people is a challenge for many businesses. Today's work force is more mobile and willing to make employment changes in the pursuit of career advancement. In order for businesses to succeed in a highly competitive labor market, they need to offer a competitive compensation and benefit package.

A basic benefit package for many businesses includes employer-subsidized health, disability income, and group life insurance as well as some form of pension and/or profit-sharing plan.

However, in order to differentiate their organization in the market, businesses need to offer additional "selective" benefits to attract and retain top executives. These may include a variety of insurance and non-insurance related programs that are offered exclusively to key people in the organization.

In most cases, executives want benefits that help them save for retirement. However, selective benefit programs such as incentive stock or deferred compensation plans may not be practical for smaller businesses. An Executive Bonus Plan offers a simple and effective way for small to mid-sized businesses to provide additional cash accumulation and death benefit protection to key executives. An Executive Bonus Plan funded with whole life insurance can be an integral part of a compensation and benefit program designed to attract, retain and reward talented employees.

Today's work force is more mobile and willing to make employment changes in the pursuit of career advancement. In order for businesses to be successful in a highly competitive labor market, they need to offer a competitive compensation and benefit package.

Bonus Plan basics

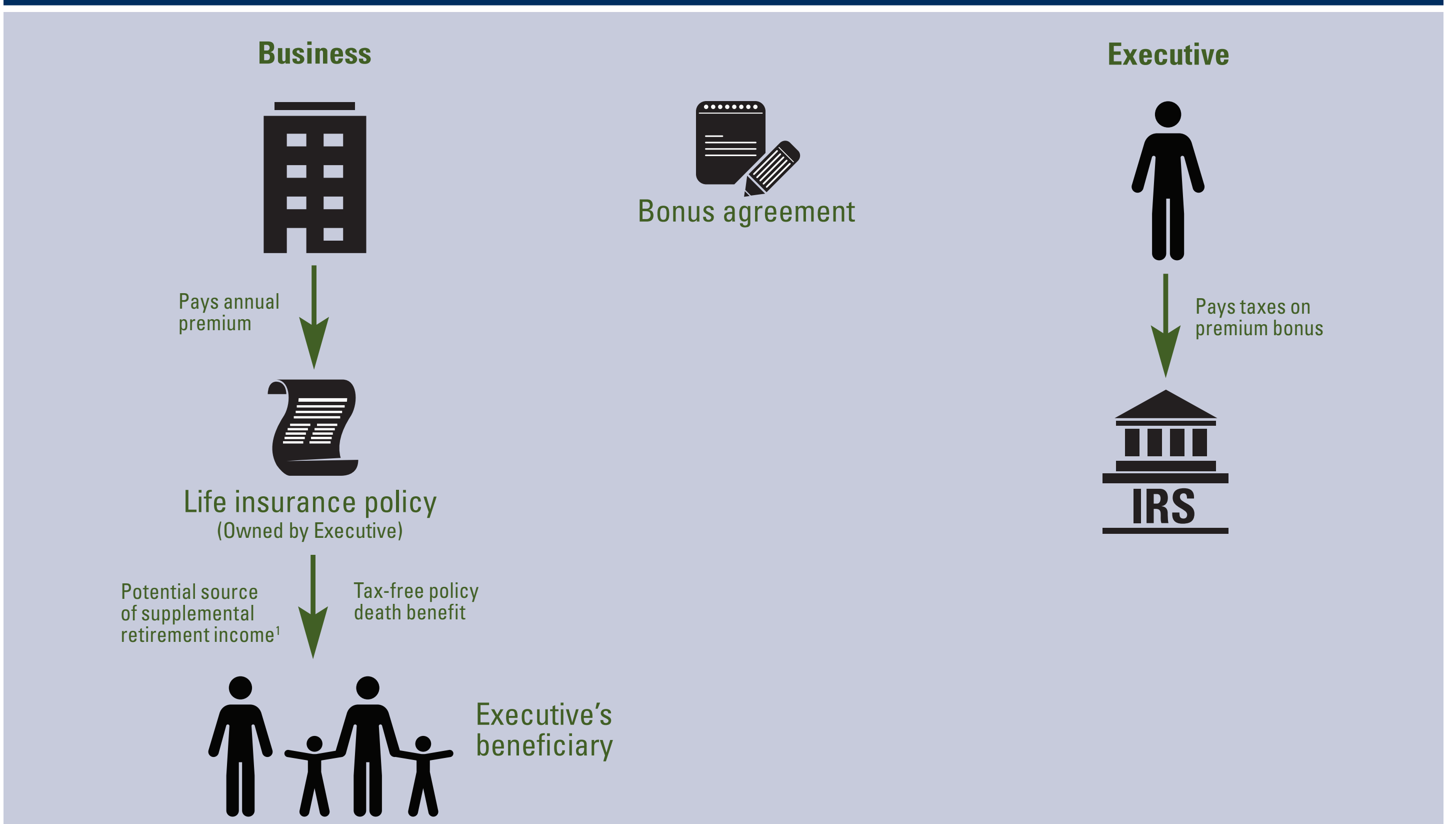
An Executive Bonus Plan is a fringe benefit plan funded with life insurance that is designed to benefit a select group of one or more key employees or business owners. Under an Executive Bonus Plan, the business enters into an agreement with an executive to pay all or part of the premiums for a life insurance policy owned by the executive. The business usually pays premiums directly to the insurance company on behalf of the executive. The bonus amount is fully tax deductible to the business, assuming it represents reasonable compensation, and is taxed as ordinary income to the executive. There are also several plan design options that can be used to tailor the plan to focus on specific business objectives.

A basic Executive Bonus Plan offered by **Business** to **Executive** would be structured as follows:

1. **Business** enters into a bonus agreement with **Executive;**
2. **Executive** applies for and owns the whole life policy;
3. **Business** pays all or a portion of the annual policy premium as a bonus; and
4. **Executive** pays the income taxes on the bonus amount each year.

The following diagram illustrates how a basic Bonus Plan works:

Executive Bonus Plan — How it works



Benefits of an Executive Bonus Plan

An Executive Bonus Plan offers multiple benefits to both the sponsoring Business and the executives covered by the plan:

Benefits to the Business

- **A Selective benefit** — The business can offer the plan to a select group of one or more employees on a discretionary basis. In addition, the business can vary the bonus amount and insurance coverage by employee. This flexibility allows the business to design a plan that appropriately rewards its most valuable executives.
- **Tax deductible** — The bonus amount is generally tax deductible by the business, provided it is considered reasonable compensation. This feature will often drive the decision for the business to implement a Bonus Plan over another type of benefit program.
- **Easy implementation and administration** — Bonus Plans are relatively easy to set up and maintain. They offer a straightforward design based on a simple agreement between the business and the executive. A basic Bonus Plan does not require IRS approval and there are generally no ERISA reporting requirements or restrictions.
- **Flexibility** — Executive Bonus Plans offer a great deal of flexibility with respect to whom they cover, the benefits they provide and the cost to the business. These plans can be designed to meet multiple financial needs and create substantial incentives that can help the business attract and retain the best people.
- **Adaptable to changing business needs** — The Bonus Plan agreement may give the business the ability to amend or terminate the plan at any time with limited notice to the executive. This may be important to smaller businesses that are concerned about being "locked" into a plan cost that they cannot reduce or suspend if the business experiences financial difficulties.

Bonus Plans offer a straightforward design based on a simple agreement between the business and the executive. A basic Bonus Plan does not require IRS approval and there are generally no ERISA reporting requirements or restrictions.

Benefits of an Executive Bonus Plan continued

An Executive Bonus Plan funded with whole life insurance will build cash value over time. These values offer a source of cash that may be used to provide supplemental income during retirement.[1]

Benefits to the Executive

- **Life insurance death benefit protection** — The executive (or his or her designee) is the owner of the policy funded by the plan and has the right to name the policy beneficiary. The life insurance can help reduce or eliminate the need for the executive to purchase life insurance on their own, and the policy death benefit will generally be received income tax-free by the beneficiary.
- **Cash accumulation** — An Executive Bonus Plan funded with whole life insurance will build cash value over time. These values offer a source of cash that may be used to provide supplemental income during retirement. Whole life policy cash values accrue tax-deferred, and can be accessed on a tax-advantaged basis.[1]
- **Portability** — If the executive leaves the business, they may continue the coverage by paying premiums out-of-pocket, or they may use policy dividends[2] and/or cash values to help pay future premiums.[3]
- **Security of policy values** — The executive has no risk of forfeiture of policy values, unless the policy has been pledged to secure a loan. Executives often view this as a key advantage of a Bonus Plan over other types of executive benefit programs, such as a Deferred Compensation Plan, where the payment of future benefits may depend upon the continued financial solvency of the business.
- **Possible creditor protection** — In many states, personally owned life insurance policy cash values are exempt from the claims of creditors. This may be an important feature for professionals or business owners who are involved in activities where personal liability is a concern.

---

1 Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty.

Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

2 Policy dividends are not guaranteed.

3 Under the APO strategy, dividends are used to buy paid-up additions. Then, premiums are paid from dividends and the surrender of paid-up additions as necessary. If actual dividends are lower than assumed in the illustration, additional out-of pocket (cash) premium payments likely will be required, or if cash premium payments have stopped, they may need to be resumed at a later date. The use of the policy's values in this fashion generally will reduce the death benefit.

Plan design options

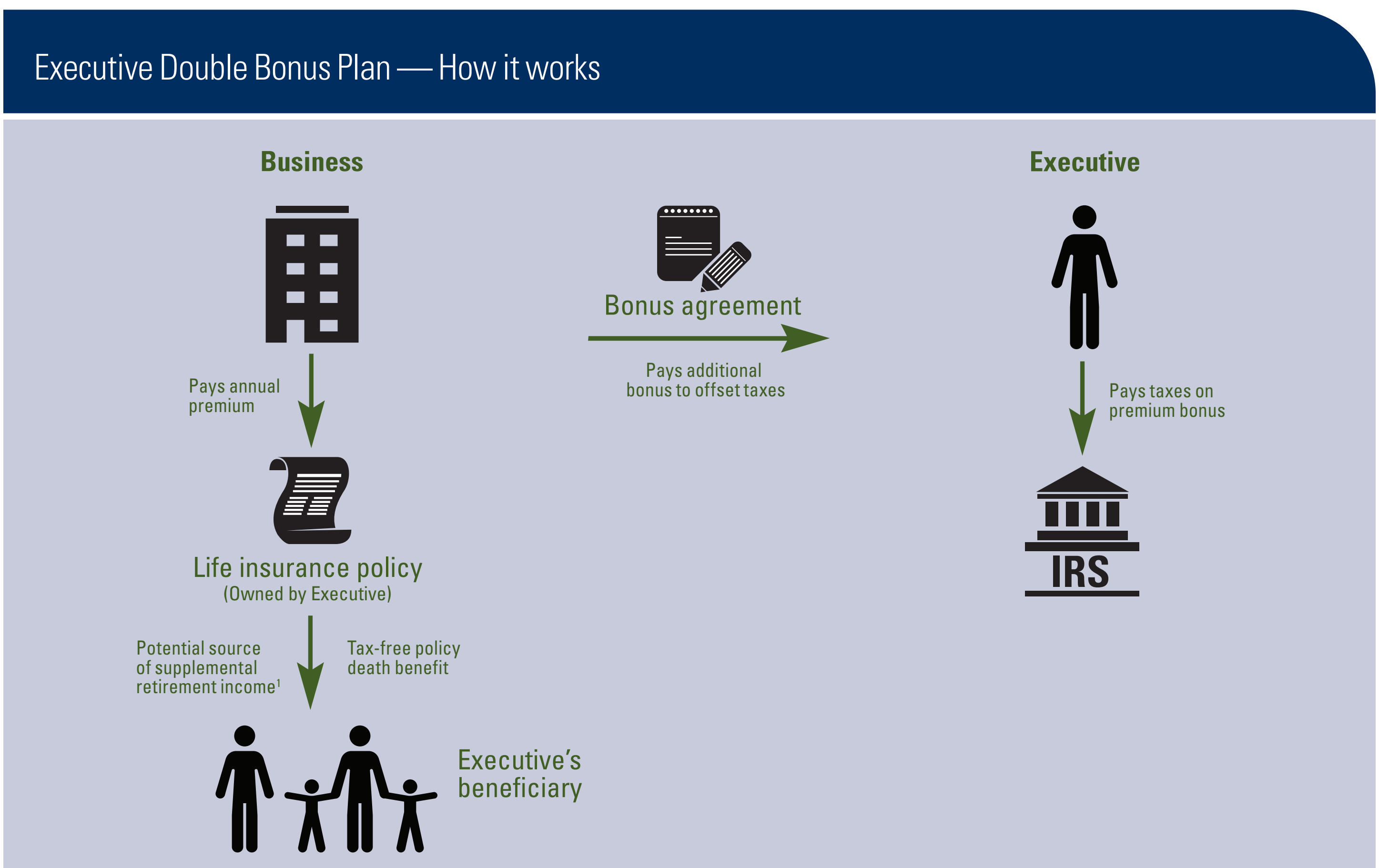
There are several plan design options that can be used to tailor a basic Bonus Plan to meet the specific objectives that the business is trying to achieve.

The Double Bonus Plan

From the executive's perspective, a disadvantage of a basic Executive Bonus Plan is that the value of the premium bonus is taxable as income each year. The Double Bonus Plan design solves this problem. Under a Double Bonus Plan, the business will pay the policy premiums and pay an additional "grossed-up" bonus to the executive to cover the income taxes due. The result is a plan that has no after-tax cost to the executive.

The Double Bonus Plan offers an attractive additional benefit to the executive. However, it presents an additional cost to the business.

The following diagram illustrates how a Double Bonus Plan works:



Plan design options continued

The Leveraged Bonus Plan

A Leveraged Bonus Plan is similar to a basic Executive Bonus Plan whereby the business bonuses the premium to the executive, who is liable for the income taxes on that bonus. However, instead of the executive paying the taxes out-of-pocket, the business loans the funds needed to pay taxes to the executive each year. The loan is secured by a collateral assignment of the policy, which restricts the executive's access to the policy cash value while the loan is outstanding. Because of the provisions of the Sarbanes-Oxley Act of 2002 that prohibit loans to executives of public companies, Leveraged Bonus Plans are not appropriate for publicly traded corporations.

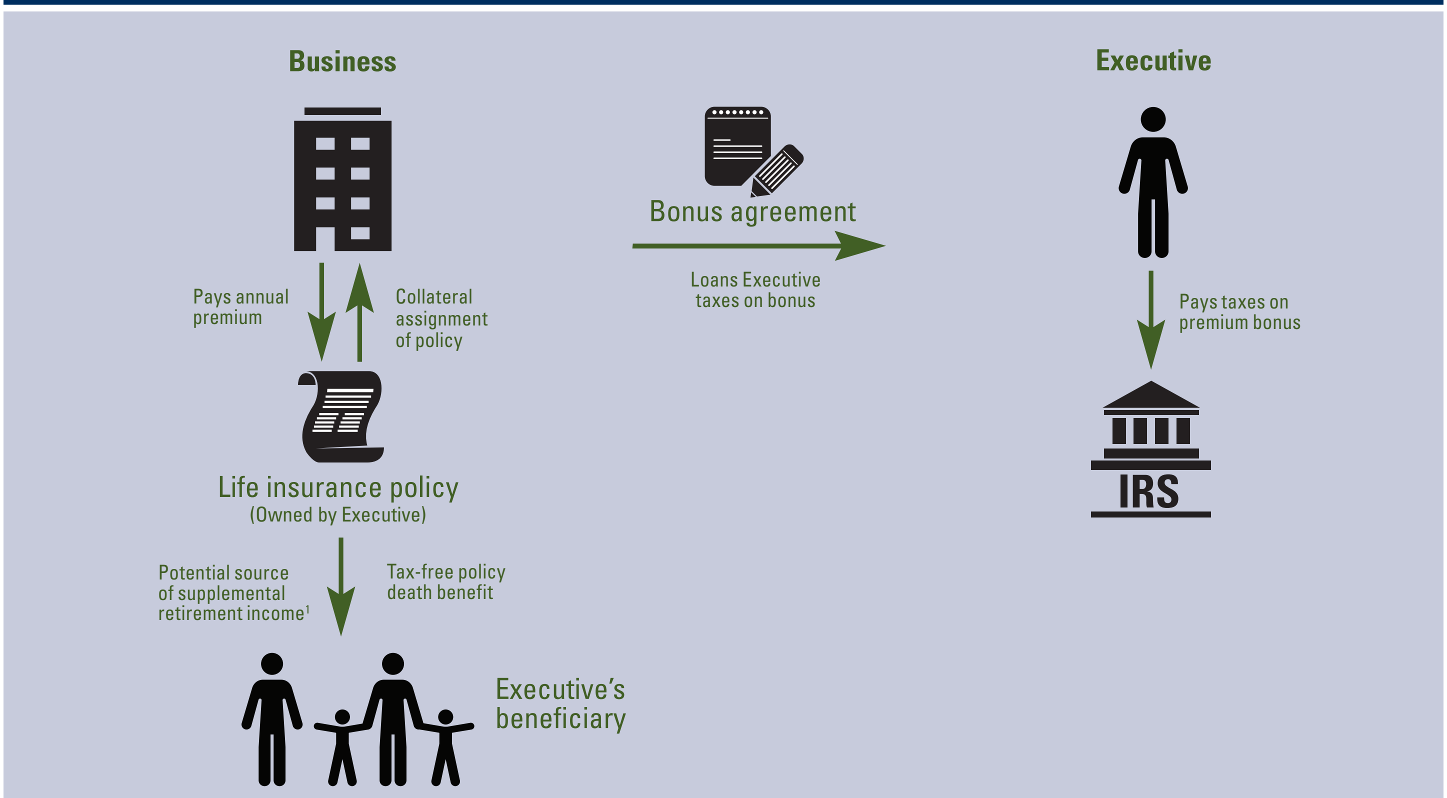
In order to avoid any immediate taxation to the executive as a result of the loan, the loan agreement between the business and the executive needs to comply with the "below market" rules established by the IRS. The business may require the executive to pay the loan interest on an annual basis, accrue (borrow) the loan interest, or the business may bonus the loan interest to the executive each year.

Typically, the plan terminates at retirement or termination of employment. At such time, the loan to the executive will generally be resolved in one of two ways:

1. The loan will either be repaid by the executive, or
2. The loan will be forgiven by the business. (See ***Important taxation and regulatory considerations concerning Leveraged Bonus Plans*** on following page.)

The following diagram illustrates how a Leveraged Bonus Plan works:

Leveraged Executive Bonus Plan — How it works



A Leveraged Bonus Plan offers the same benefits to both the business and the executive as a basic Bonus Plan. In addition, the plan does not require the executive to pay taxes out-of-pocket during the loan period. If the executive terminates employment prior to repayment or forgiveness of the loan, the business may recover the amount of the loan directly from the policy since the loan is secured by a collateral assignment of the policy. This creates an incentive for the executive to remain with the business.

Important taxation and regulatory considerations concerning Leveraged Bonus Plans

The Leveraged Bonus collateral assignment may be terminated before death through repayment by the executive, or forgiveness by the business. If termination is illustrated, the costs and/or income tax implications are reflected.

If loan forgiveness is illustrated, the plan is likely to be classified as a Deferred Compensation Plan and subject to the requirements of Internal Revenue Code Section 409A. *In addition, if this plan is classified as a Deferred Compensation Plan, ERISA filing and other legal requirements will apply.*

Any promise (expressed or implied by facts and circumstances or patterns of practice) by the business to transfer cash value or forgive the loan to the executive upon termination of the loan agreement is a form of Deferred Compensation subject to Section 409A. Section 409A requires a written plan document and limits the circumstances for triggering the receipt of benefits (for example, a provision allowing the participant to accelerate retirement benefits is generally not allowed). If the requirements of Section 409A are not met, the participant may be subject to less favorable tax treatment including substantial tax penalties. The rules under Section 409A are complex. The executive is encouraged to consult with his/her independent tax counsel or advisor.

Plan design options continued

The Restricted Bonus Plan

There may be instances where the business sponsoring a Bonus Plan wants to prevent the executive from accessing the policy cash values for a period of time. This can be accomplished by adding a provision to the Bonus Plan agreement that requires the addition of a restrictive endorsement to the policy that prevents the executive from exercising certain ownership rights for a specified period of time.

However, these restrictions only limit the executive's ability to exercise certain policy ownership rights for a certain period of time. **They do not give the business a direct interest in the policy or the right to recover any part of the plan cost from the policy.**

A Restricted Bonus Plan may not be well received by executives if they are incurring additional income taxes as a result of the plan. In addition, these plans need to be designed and implemented by your tax and legal advisors to ensure that they do not create unexpected tax consequences, legal obligations or regulatory requirements for the business. In many cases, an alternative type of plan, such as a Leveraged Bonus Plan, can achieve similar results and avoid many of the issues with a Restricted Bonus Plan.

A practical solution

The security and value of whole life insurance

Participating whole life insurance from MassMutual provides permanent life insurance protection with guaranteed premiums and policy cash values. In addition, the policy may pay dividends[2] that can be applied to purchase additional life insurance coverage and accumulate additional cash value. Whole life insurance offers a unique combination of security and value to policy owners.

An Executive Bonus Plan funded with whole life insurance can provide tax-deferred accumulation and tax-advantaged supplemental retirement income.[1] In addition, the income tax-free policy death benefit can help protect the executives' income during their working years, and ultimately may assure a legacy to their families.

These features make an Executive Bonus Plan funded with whole life insurance a good choice for executives who can benefit from the protection, cash accumulation and tax advantages that the product offers.

A practical executive benefit solution

Executive Bonus Plans offer a practical solution to the executive benefit planning needs of many small to mid-sized businesses. Bonus Plans provide valuable benefits to executives that can incent performance and promote loyalty. They are a simple, cost effective and flexible way to help a business succeed by attracting and retaining key talent.

The MassMutual Difference

Massachusetts Mutual Life Insurance Company (MassMutual) understands the needs of today's business owners — we've been working with successful people like you for over 160 years. Our financial professionals will take the time to listen, learn about you and your enterprise and help develop strategies that you feel are best suited to your needs. Talk to your MassMutual financial professional about helping you design an Executive Bonus Plan to reward your most important assets — your employees — and help ensure the continued success of your business.

MassMutual. We'll help you get there.®

There are many reasons to choose a life insurance company to help meet your financial needs: protection for your family or business, products to provide supplemental income and the confidence of knowing you will be prepared for the future.

At Massachusetts Mutual Life Insurance Company (MassMutual), we operate for the benefit of our participating policy owners. We stand strong in the fundamental belief that every secure future begins with a good decision. And when choosing a life insurance company – ownership, strength and stability matter.

Learn more at www.massmutual.com/mutuality

MassMutual
FINANCIAL GROUP®

LI7267 212 CRN201403-156242