Death Proceeds on Employer-Owned Life Insurance Subject to Taxation

Question: I have heard that tax legislation made *employer-owned* life insurance taxable. Would you help clarify this and explain what impact this legislation has on common business uses of life insurance such as deferred compensation arrangements, key person coverage, and buy-sell arrangements?

Answer: Provisions of the Pension Protection Act of 2006 state that for *employer-owned contracts* issued after August 17, 2006, death benefits will be taxed as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer.[1]

At first glance, the legislation seems to negatively impact many business uses of life insurance. Fortunately, the rules also provide that if certain notice and consent requirements are met and if certain exceptions apply, death benefits will still pass income tax-free.

Thus, the key to avoiding taxation of employer-owned life insurance death benefits is to follow the rules. Let's start by looking at the definitions.

Employer-Owned Contract. The Pension Protection Act defines an *employer-owned contract* as a life insurance contract:

- That is owned by a person engaged in a trade or business (*applicable policyholder*, as defined by law)
- Under which, the applicable policyholder, or related person (as defined by the law), is directly or indirectly a beneficiary, and
- That covers an insured who is an employee of the trade or business of the applicable policyholder on the date the contract is issued.

Clearly, this definition includes policies where a business is the owner and beneficiary. What's not so obvious is that under the *applicable policyholder* and *related party* definitions, the legislation expands its reach to a broad group of individuals and entities such as family members, trusts, and estates.

Applicable Policyholder and Related Party. As defined, the term *applicable policyholder* includes a trade or business that owns the contract but also includes any individual who bears a relationship to the applicable policyholder if that relationship is described under any of the following sets of *related party* rules:

- IRC § 267(b), the constructive ownership rules,
- IRC § 707(b)(1), dealing with transactions between a partner and a partnership, or
- IRC §52(a), (b), the common control rules applicable to corporations.

The related party provision is important since it broadens the reach of the rules beyond policies owned by a trade or business. The question is how far was it meant to reach?

Fortunately, in Notice 2009-48, the IRS clarified that to be an employer-owned contract the person owning the policy must be engaged in a trade or business. Consequently, contracts owned by qualified plans or a VEBA that is sponsored by an entity engaged in a trade or business is not subject to the EOLI rules. Likewise, contracts owned by the owner of an entity engaged in a trade or business is not

[1] *IRC § 101(j)*

subject to the EOLI rules. However, a contract that is owned by a grantor trust the assets which are treated as assets of a grantor that is engaged in a trade or business may be an employer-owned contract – think Rabbi trust.

In light of the broad reach of these rules, it is important that business owners work with their tax and legal counsel to see if any of the *related party* rules are applicable prior to implementing and placing a life insurance policy on an employee.

Notice and Consent Requirements. Congress apparently was aware that the broad definitions of the terms, *employer-owned contract, applicable policyholder,* and *related party* could negatively impact many valid business uses, so it included a number of exceptions. However, the exceptions apply only if the employee receives specific *notice and consent* **in writing prior to policy issue.** Meeting the notice and consent requirements is a critical first step to avoiding taxation of death benefits applicable to employer-owned contracts.

Under the notice and consent rules, the following actions must be taken by an applicable policyholder before a life insurance contract is issued:

- The employee must receive written notification of the applicable policyholder's intention to insure the employee's life, and such notification must specify the maximum face amount for which the employee could be insured at time of issue;
- The employee must provide written consent that he or she is aware of the insurance coverage and that the coverage may continue after he or she terminates employment; and
- The applicable policyholder must inform the employee in writing that the policyholder will be the beneficiary of any death benefits paid.[2]

Failure to meet the notice and consent requirements prior to policy issue will result in the death benefits being subject to ordinary income tax. When is a policy considered issued?

When the law was first established it did not contain a definition of when a contact was considered issued. Notice 2009-48 provided the following explanation. For purposes of determining whether the notice and consent are timely "issue" is considered the later of:

- Date of application of coverage,
- Effective date of coverage, or
- Formal issuance of the contract.

Proper notice and consent is not the only requirement imposed by the legislation. As indicated earlier, to avoid being subject to income taxation, employer-owned contracts must also meet the terms of one of the following exceptions.

Exception Based on an Insured's Status. This exception provides that the income inclusion rule will not apply to employer-owned life insurance provided that proper notice and consent is given and the insured individual was either:

- An employee at any time during the 12-month period before the insured's death, or
- A director, a highly compensated employee, or a highly compensated individual **at the time the contract was issued.**

[2] *Note: To help our customers comply with these new requirements, Prudential has developed a sample Notice and Acknowledgement of Consent to Insurance document found in ATTENTION EMPLOYERS – Employer-Owned Life Insurance Rules Have Changed – 0150882-00001-00.*

Highly compensated employees are defined using the rules found in IRC § 414(q) and include employees who, during the preceding year, were 5% owners of the business or had compensation in excess of a specified dollar amount ($105,000 for 2008, $110,000 for 2009, increased for inflation in future years).

Note: Because of the reference to IRC § 414(q) and wording in that Internal Revenue Code section, employees include independent contractors, self employed individuals and former employees.

Highly compensated individuals are defined under IRC § 105(h)(5) to include the five highest-paid officers or to be among the highest paid 35 percent of all employees.[3]

Exception Based on the Individuals Who Receive the Death Benefit Proceeds. This exception states that, provided proper notice and consent is given, the income inclusion rule will not apply to an amount received at the death of an insured to the extent the amount is paid:

- To a family member of the insured,
- To an individual, other than an applicable policyholder, who is the designated beneficiary of the insured,
- To a trust established for the benefit of any such member of the family or designated beneficiary,
- To the estate of the insured, or
- Where the policy proceeds are used to purchase an interest in the applicable policyholder from such family member, beneficiary, trust, or estate.

Finally, the legislation mandated annual reporting. The IRS has provided Form 8925 for this purpose.

Reporting and Record Maintenance Requirements. Under the new rules, applicable policyholders who have employer-owned contracts are required to file Form 8925 with the Internal Revenue Service (IRS) for each year the contracts are owned. Form 8925 requires the following information:

- The number of employees the policyholder had at the end of the year;
- The number of those employees who were insured under such contracts at the end of the year;
- The total amount of employer-owned insurance in force at the end of the tax year under such contracts;
- The name, address, taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged; and
- Attestation that the applicable policyholder has obtained valid consent from each insured, or where all consents are not obtained, the number of insureds from whom such consent was not obtained.

In light of these reporting rules, it is extremely important that applicable policyholders maintain records documenting that they have timely met the notice and consent requirement.

Effective Date of the New Rules. These rules took effect for contracts issued after August 17, 2006, the date of enactment of the Pension Protection Act.

The rules do not apply to a like-kind IRC § 1035 exchange of a contract issued on or before August 17, 2006, and Form 8925 is not required for such a change. However, any material increase in the death benefit or material change will cause the contract to be treated as a new contract (except with respect to a master contract, where the addition of covered lives is treated as a new contract only with respect to the added lives).

Because of the uncertainty about what is considered a *material change*, fewer IRC § 1035

[3] *Note that 35% has been substituted for the 25% generally applicable under IRC § 105(h)(5).*

exchanges than originally thought may be grandfathered.

Notice 2009-48 sheds some light on the subject by stating that none of the following will be considered a *material change*:

- Administrative changes
- Changes from general to separate account
- Changes resulting from the exercise of an option or right granted under the contract as originally issued
- Increases in the death benefit occurring as a result of the operation of IRC § 7702

The Notice does not address many other situations. For example, is a carrier change considered a *material change*?

Correcting a Violation. Initially, most advisors believed that once the employer-owned life insurance rules were violated there was no means to correct the situation other than to start over. However, in Notice 2009-48 the IRS indicated that by doing a Section 1035 exchange to a larger face amount (or other material modification), it's possible to correct a violation by complying with the rules prior to the issue of the new policy.

In Summary. The employer-owned life insurance rules have not ruled out income tax-free death benefits where a life insurance policy is owned by a business; however, specific requirements must be meet. Specifically, the employer must now meet notice and consent requirements prior to policy issue; file Form 8925 annually with the IRS when such policies are in place; and limit coverage to certain individuals or restrict who receives policy benefits.

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