

Employer Owned Life Insurance Now Considered Taxable!

Under new Internal Revenue Code Section 101(j), which was added to the code by the Pension Protection Act of 2006, life insurance death proceeds paid on employer owned policies issued after August 17, 2006 are income taxable to the employer to the extent they exceed the employer's basis in the policy.

The preceding statement is not a misprint. The Pension Act made death proceeds paid on employer owned life insurance policies (EOLI) income taxable. But there is good news here. The good news is that this devastating tax treatment can be avoided by a business owner, with our assistance.

A Broad Scope

Section 101(j) has a broad scope. It applies to every type and size of business—from Fortune 500 companies, to one-person sole proprietorships. It applies to every type and size of policy purchased on an employee's life and payable to the business, regardless of the purpose of the policy. And, as stated above, it applies now: to any policy issued after August 17, 2006.

There is no remedial process built into the law for contracts issued after August 17, 2006 without the required notice and consent (see below). It appears the only remedy is to start over with a new contract.

Policies issued by August 17, 2006, and policies issued pursuant to a Section 1035 exchange of such pre-existing policies, are grandfathered and not subject to the new law. A material change (not yet defined) to a grandfathered policy will, however, bring the policy under the new rules.

The Fix

The new code section creates an exception framework which will allow your informed business clients to keep the death benefits on their EOLI policies income tax free.

Specifically, in order for the death benefit on an EOLI policy to be income tax free, the insured must fall into one of two safe harbor categories, and the employer must meet certain notice and consent requirements concerning the insured.

Safe Harbors

In order to retain the income tax free status of EOLI policy death benefits, the insured must have been either a) employed by the employer within 12 months of death, or b) a director or highly compensated individual or employee of the employer at the time the policy was issued.

Note that if the insured falls into the first category (employed within 12 months of death) the insured's position within the business while living is irrelevant. Conversely, if the insured met the director or highly compensated individual or employee requirement at issue, the insured's employment status, or relationship to the employer at death, does not matter.

For purposes of this section, a director or highly compensated employee will be an individual who, at the time the policy was issued, was:

- A Director, Or
- A 5% Or Greater Owner Of The Business At Any Time During The Preceding Year, Or
- An Individual Who Received Compensation Greater Than \$95,000 In The Preceding Year, Or
- Among The Five Highest Paid Officers, Or
- Among The Highest Paid 35% Of All Employees

Notice and Consent

Assuming the insured falls into one of the above safe-harbors, the death benefit will be income-tax free if, before the policy is issued, the employer meets the notice and consent requirements of the new law.

To Meet Those Requirements, The Insured Must Be Notified Of The Following In Writing:

- That the employer intends to insure his or her life
- The maximum amount of insurance for which the employee may be insured (this presumably means the maximum face amount for which the employer will apply.)
- That the employer may retain the policy in force after the insured has left employment
- That the employer will be the beneficiary of some or all of the death benefit.

The employee must provide written consent to being insured under the policy, and to the employer's retention of the policy after the employee leaves employment.

Employer Reporting Requirement

Employers who own EOLI contracts must file an annual report with the IRS. This report must specify:

- The Total Number Of Employees Employed By The Business At The End Of The Year
- The Number Of Those Employees Insured Under EOLI Contracts At The End Of The Year
- The Total Amount Of EOLI Insurance In Force At The End Of The Year
- The Employer's Address, Taxpayer Identification Number, And Type Of Business
- That The Employer Has A Valid Consent From Each Insured Employee, And The Number Of Insured From Whom Consent Was Not Obtained, If Any.

The broad scope of this new code section creates a potential tax trap. You can provide a valuable service to your business clients and their advisors by providing them with the information needed to avoid this trap, and preserve the income-tax free status of their EOLI policies.

Additional Questions

If you have questions, please call MillerMusmar Tax Manager, Leonard Trester at 703-437-8877 ext. 122.