ADVANCED PLANNING

Business Strategies

Employer-Owned Life Insurance Rules

Are you thinking about purchasing key person life insurance on your life or the life of one of your employees to help protect the business against financial loss when either of you die? Perhaps you are considering purchasing life insurance to assist in financing the cost of employee benefit plans or to help fund the purchase of a business interest under the terms of a buy-sell agreement. If so, it's important to understand the rules.

RULES FOR EMPLOYER-OWNED LIFE INSURANCE

For employer-owned contracts issued after August 17, 2006, the Pension Protection Act generally provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain exceptions apply, death proceeds can be received income tax-free.

Meeting the notice and consent requirements is a critical first step to avoiding taxation of death benefits applicable to employer-owned contracts. However, notice and consent is not the only requirement imposed by the legislation. Employer-owned contracts must also fall within one of the outlined exceptions found in this article.

What Is an Employer-Owned Contract?

The starting point to understanding the impact of the legislation is to recognize what it calls an employer-owned contract. An employer-owned contract is defined as a life insurance contract:

- that is owned by a person engaged in a trade or business (applicable policyholder, as defined by the law).
- under which such person, or related person (as defined by the law), is directly or indirectly a beneficiary.
- 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.

Notice and Consent Required Prior to Issue

Congress apparently was aware that this broad definition could negatively impact many valid business uses, so it included a number of exceptions in the legislation. However, the exceptions apply only where the employee receives **notice of, and consents to, the following in writing prior to policy issue**:

- The applicable policyholder intends to insure the employee's life and specifies the maximum face amount for which the employee will be insured at time of issue.
- The employee consents to being insured and agrees that such coverage may continue after he or she terminates employment, and
- The applicable policyholder will be the beneficiary of the death proceeds paid.

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Exception: Based on an Insured's Status

This exception provides that the income inclusion rule will not apply to employer-owned contracts provided the insured was either:

- An employee at any time during the 12-month period before the death.
- A director, a highly compensated employee,[1] or a highly compensated individual[2] at the time the contract was issued.

Exception: Based on Who Receives the Death Benefit Proceeds

This exception states that 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.
- an individual, other than an applicable policyholder, who is the designated beneficiary of the insured.
- a trust established for the benefit of a family member or designated beneficiary.
- the estate of the insured.
- such family member, beneficiary, trust, or estate to purchase an interest in the applicable policyholder.

Reporting & Record-Keeping Requirements

The legislation also mandates annual reporting of employer-owned contracts for each year the contracts are owned. This reporting is provided on IRS Form 8925 and attached to the policyholder's tax return. Form 8925 requires the following:

- The number of employees at the end of the year.
- The number of employees insured under such contracts.
- The total amount of insurance in force under such contracts.
- The name, address, and taxpayer identification number of the applicable policyholder as well as the type of business.
- An attestation that valid consent has been obtained from each insured, or where all consents have not been obtained, the number of insureds for whom such consent was not obtained.

Important: Because of these reporting rules, it's extremely important that you maintain documentation that proves that you have met the notice and consent requirements in a timely manner.

Remember

Life insurance policies can still provide income tax-free death benefits to help you meet your business goals, but the key to a successful strategy is following the rules. In light of the broad application of this legislation, it is important that you understand these rules before entering into a transaction involving an employer-owned life insurance contract.

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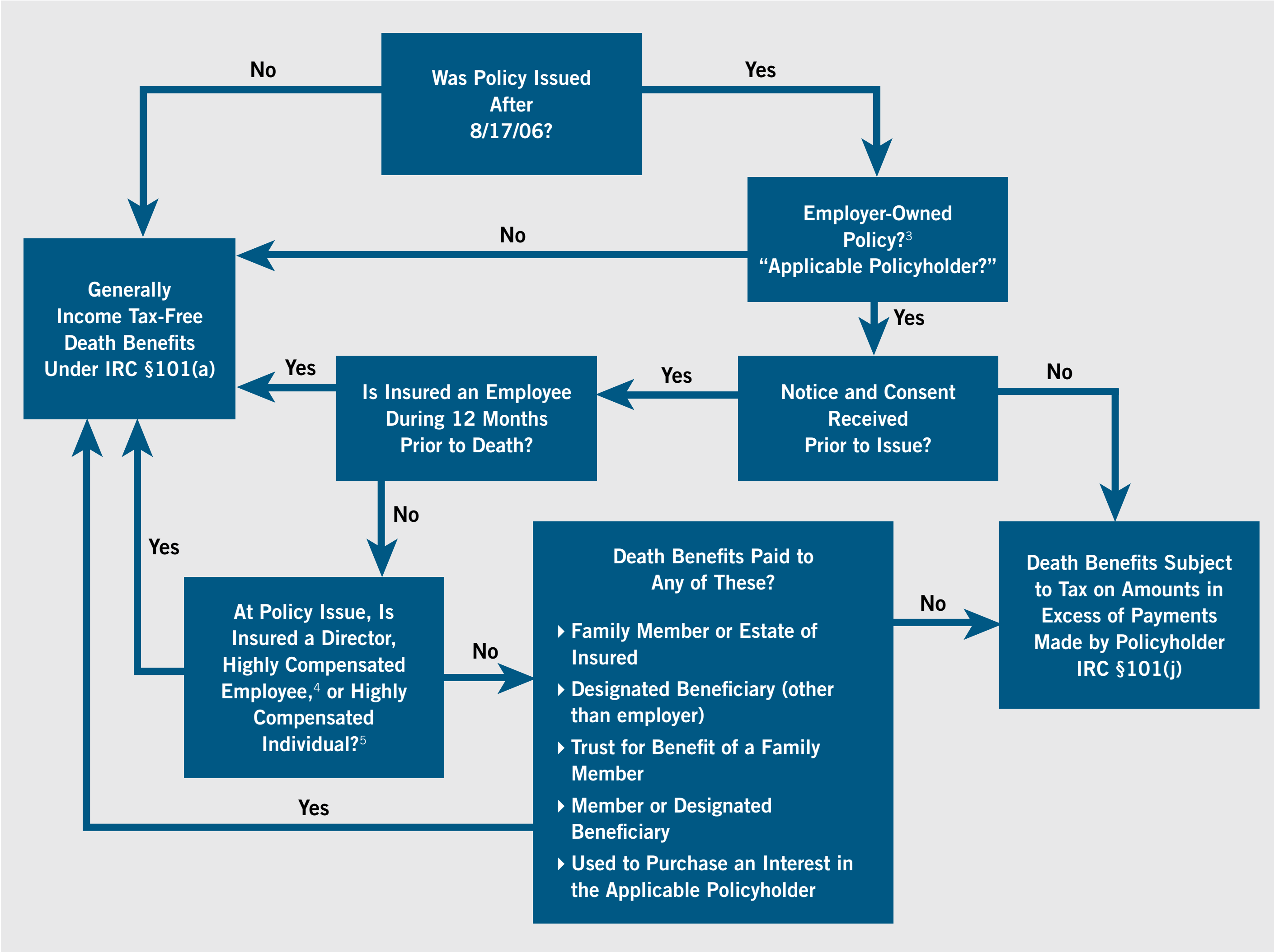
[1] Highly compensated employees include employees who were 5% owners of the business at any time during the preceding year or who received compensation in excess of a specific amount during the preceding year ($130,000/$130,000 if the look-back year is 2020/2021, indexed for inflation in future years). The definition of a highly compensated employee is set forth in IRC §414(q)(1)(B).

[2] Highly compensated individuals include the five highest-paid officers or individuals who are among the highest-paid 35% of all employees.

EMPLOYER-OWNED LIFE INSURANCE CONTRACTS—POST AUGUST 17, 2006[3]

This diagram gives you a quick overview of how to determine whether the death benefits will be subject to taxation.



[3] The Pension Protection Act of 2006 defined an employer-owned life insurance contract as a policy owned by a person engaged in a trade or business (the "applicable policyholder") under which such person, or a "related person," is directly or indirectly a beneficiary, and where the insured is an employee of the trade or business of the applicable policyholder on the date the policy is issued. Applicable policyholder includes a "related party," which is defined as a person that bears a relationship described under IRC §267(b), the constructive ownership rules; IRC §707(b)(1), dealing with transactions between a partner and a partnership; and IRC §52(a),(b), the common control rules applicable to corporations.

[4] As defined under IRC §414(q), includes employees who were 5% owners of the business during the preceding year or had compensation in excess of a specified dollar amount.

[5] As defined under IRC §105(h)(5), includes the five highest-paid officers and those individuals among the highest-paid 35% of all employees.

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A sample generic Acknowledgment and Consent to Employer-Owned Life Insurance form appears below. Please be aware that this form has not been adapted to the specific circumstances or objectives of an individual employer. Neither The Prudential Insurance Company of America nor its representatives provide tax or legal advice. We strongly urge you to consult with your attorney to understand the application of these rules to your situation before completing an employer-owned life insurance transaction.

Acknowledgment and Consent to Employer-Owned Life Insurance

Proposed Insured Name: ____

Employer/Applicable Policyholder Name: ________________________________

Employer/Applicable Policyholder Address: ______________________________

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Employee Acknowledgment and Consent

The employer/applicable policyholder has given me notice that it intends to purchase a life insurance policy or policies on my life. I understand and consent to the following:

- I will be the insured under the policy(ies).
- The employer/applicable policyholder will own the policy.
- The employer/applicable policyholder may, directly or indirectly, be a beneficiary of the policy(ies) and may receive proceeds payable on my death.
- The employer/applicable policyholder, or its successors, may continue to be the owner and/ or may be a beneficiary of the policy even after my employment terminates.
- $______________________ is the maximum face amount for which I may be insured by the employer/applicable policyholder at time of issue.

X ______________________________ ______________________________

Signature of the Proposed Insured Date