Protect key assets with a Performance Evaluation of Your Employer-Owned Life Insurance

Established processes for employer-owned contracts preserve the death benefit and may avoid significant tax consequences.

Update Your Needs Analysis

Change is one thing you can count on. Business start-ups become industry leaders. Children grow up and have children of their own. Bigger houses, smaller houses, vacation houses, and rental properties. Life changing events may occur such as college tuition, retirement, disability, divorce and death.

A lot can change in your life after you buy a life insurance policy – and those changes can impact your policy. Performance Evaluation helps keep your financial strategy intact. If needs or plans have changed, your policy may require to be adjusted to fit new circumstances. You may have too little or too much insurance for the present situation and future goals.

Given the impact of the Estate Tax Exemption of $5,250,000 for 2013, individuals that have an exorbitant amount of life insurance are re-evaluating their existing life insurance portfolio to determine how they can restructure their current policies to be utilized for another purpose; perhaps to provide an income stream or serve as a long term care benefit.

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PERFORMANCE EVALUATION

Employer Owned
LIFE INSURANCE

PROCESS THAT PROTECTS

I.R.C. §101(j):
Treatment of Certain Employer-Owned Life Insurance Contracts

On May 26, 2009, the Treasury issued Notice 2009-48 which provides additional guidance regarding the treatment of employer-owned life insurance contracts under Section 101(j) of the IRC of 1986, as amended and the recordkeeping and return requirements under Section 6039I.

Many employers purchase life insurance on their employees. These employer-owned life insurance (EOLI) policies generally refer to life insurance contracts that cover the lives of a company's employees and with respect to which the company is the owner and beneficiary of all or some portion of the death benefits. Companies may invest in these employer-owned life insurance contracts for several reasons, including (1) key man life insurance coverage, (2) funding various qualified and non-qualified deferred compensation and benefit arrangements, and (3) funding the payment obligations associated with certain buy-sell agreements.

Generally, the death benefits payable under a life insurance contract are tax-free under the exclusion of Section 101(a). However, this exclusion does not apply to employer-owned life insurance contracts unless the insured employees receive notice of and consent to the company's acquisition of life insurance contracts prior to their issuance. Companies that purchase employer-owned life insurance contracts are subject to ongoing obligations to report certain information on the company's federal tax return each year the contracts are owned.

The general rule limits the amount of death benefits under EOLI contracts that may be tax-free.

Section 101(j) limits the amount of death benefits payable under an employer-owned life insurance policy that may be received by a company on a tax-free basis to the sum of the premiums and other amounts paid by the company.

Compliance with these requirements may protect the death benefit from being included in gross income calculations.

Failure to comply can result in income taxation of the death benefit, resulting in a serious shortfall of funds at a time when the employer needs it most.

Performance Evaluation for Your Employer-Owned Life Insurance

Notice 2009-48 Treatment of Certain Employer-Owned Life Insurance Contracts

Notice 2009-48 provides additional guidance regarding the application of Sections 101(j) and 6039I to employer-owned life insurance contracts, including guidance addressing the definition of a life insurance contract, exceptions to the general rule limiting the amount of death benefits that may be excluded from the policyholder's gross income, the satisfaction of the notice and consent requirements, and the report requirements. Federal income taxation may be avoided only when the employer complies with certain IRS rules.

Performance Evaluation outlines the processes that protect death benefits from unnecessary taxation with an eye towards maximizing contract value.

Exceptions

Income Exclusion Limitation

Sections 101(j)(2)(A) and 101(j)(2)(B) provide several exceptions to the general exclusion limitation if an EOLI contract meets certain notice and consent requirements. These exceptions provide that the income exclusion limitation under Section 101(j)(1) does not apply to:

- Any amount received by reason of the death of an insured who, with respect to the policyholder, was an employee during the 12-month period before the insured's death or is at the time the contract is issued, a director, or a highly compensated employee.[1]
- Any amount received by reason of the death of an insured to the extent that
  - o The amount is paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract, a trust established for the benefit of any member of the family or the estate of the insured.
  - o The amount is utilized to purchase an equity interest in the policyholder from any person described above.

Section 101(j)(2) provides several exceptions to Section 101(j)(1) which limits the amount of death benefits that may be received by a company on a tax-free basis from an employer-owned life insurance contract. Notice 2009-48 provides that generally, the issue date of the contract is the date on the policy assigned by the insurance company. For purposes of qualifying under the exception applicable to the use of death benefits for the purchase of equity interests from the insured's heirs, the payment for the equity interests must be paid by the due date, including extensions.

[1]Please see Section 101(j)(1) for further details of how a highly compensated employee is defined.

Notice & Consent Requirements

If the death benefits received by the company qualify under one of these exceptions, then the company will be eligible to receive the full amount of death benefits payable under an employer-owned life insurance contract on a tax-free basis, but only if the company complies with three notice and consent requirements:

- The company must notify the employee in writing that the company intends to insure the employee's life and of the maximum face amount for which the employee could be insured when the contract is issued.
- The company must inform the employee in writing that the company or a related person will be a beneficiary of any proceeds payable upon the death of the employee.
- The employee must provide written consent to being insured under the contract and that the coverage under the contract may continue after the employee terminates.

Under Notice 2009-48, satisfaction of the notice and consent requirements must be met. The notice and consent is required by an owner-employee of a wholly-owned corporation. The actual transfer of an existing life insurance policy by an employee to an employer is sufficient to satisfy the requirements that the employee be notified in writing of the intention to insure and the maximum face amount of the insurance, that written consent be secured and the employee be notified that the employer will be a beneficiary upon his or her death. In order to prevent the expiration of an employee's consent, the life insurance contract must be issued the earlier of:

1. The expiration of the one-year period beginning on the date the consent was executed, or
2. Termination of the employee's employment with respect to the trade or business of the policyholder.

Reporting & Record Keeping Requirements

Section 6039I requires that a company owning one or more employer-owned life insurance contracts issued after August 17, 2006, file form 8925 with the company's tax return, indicating the following information for each year the contracts are owned:

- The number of those employees insured under EOLI at the end of the year;
- The total amount of insurance inforce at the end of the year under those contracts;
- The company has a valid consent for each employee;
- The company must keep any records that may be necessary for purposes of determining whether the requirements of Sections 101(j) and 6039I are met.

Notice 2009-48 provides that for purposes of determining the "applicable policyholder" that must comply with these informational reporting obligations, the only entity that must file the form 8925 is the actual owner of the policy (even though other entities that are related to that owner otherwise fall within the definition of an applicable policyholder).