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EMPLOYER OWNED LIFE INSURANCE ALERT:
How the New Rules Apply to Business

The Pension Protection Act of 2006 ("PPA") established reporting requirements and income inclusion rules applicable to an employer that is a direct or indirect beneficiary of a life insurance policy covering one or more of its employees. While life insurance proceeds are generally exempt from taxation, Section 101(j) of the Internal Revenue Code (IRC) now provides that only the portion of death benefits equal to premiums or other amounts paid by the employer for the policy may be excluded from gross income. Death benefits in excess of this amount are includible in gross income and subject to taxation unless an exception applies. This new provision is generally applicable to employer owned life insurance ("EOLI") contracts that were issued after PPA's enactment on August 17, 2006.

The new provision broadly defines EOLI contracts as any life insurance policy owned by a person engaged in a trade or business, insuring an individual who is an employee on the date of issuance, and names such person, or a "related person" as the direct or indirect beneficiary. A "related person" includes family members, business entities and their majority owners, trust fiduciaries and grantors or beneficiaries, a person and a § 501 organization controlled by such person or his or her family, and certain controlled groups of corporations and their employees. A contract issued pursuant to an exchange for a contract issued on or before August 17, 2006, as permitted by IRC Section 1035, may also be implicated if there is a material increase in the death benefit or other material change in the contract. As the materiality of such a change may be difficult to assess, employers may wish to seek an exception to EOLI provisions in all such cases.

Another potential application of the EOLI provisions is to self-employed individuals. The "employees" who are the subject of EOLI contracts include officers, directors and "highly compensated employees." The IRS may interpret "employees" to go beyond common law and statutory definitions of employees to include self-employed individuals who are treated as employees. For example, in the unlikely event that an employer insured the life of an independent contractor meeting the definition of "highly compensated employee," the EOLI provisions may apply.

An exception to the EOLI provisions, allowing the full amount of death benefits to be excluded from gross income, may apply if the applicable notice and content requirements are met ***prior to*** the issuance of any policy. First, the employee must receive written notification of the employer's intent to insure the employee's life, the maximum face amount for which the employee could be insured, and the employer's status as the intended beneficiary of the policy. Second, the employee must provide written consent to being insured and that such coverage may continue after his or her termination of employment. An insurance provider should be able to provide employers with the necessary notice and consent forms, but employers will want to verify that the forms contain all provisions necessary for compliance.

In addition to the notice and consent requirements, one of the following exceptions must also be met in order to avoid taxation on death benefits in excess of premiums or other payments made on the EOLI contract:

1. At any time during the 12 months prior to death the insured was an employee.
2. At the time the insurance contract was issued, the insured was:
   - a. A director;
   - b. A "highly compensated employee," defined as
     - i. A five percent owner of the employer at any time during the current or preceding year, or
     - ii. Receiving over $100,000 in compensation (note: this compensation amount is adjusted for inflation); or
   - c. A "highly compensated individual," defined as
     - i. An employee who is one of the five highest paid officers of the employer;
     - ii. A shareholder owning more than 10 percent of the value of the employer's stock; or
     - iii. An employee who is among the highest paid 35 percent of all employees.
3. Death benefits received under an EOLI contract are paid to:
   - a. An insured's family member (i.e., spouse, siblings, ancestors, and lineal descendants);
   - b. A designated beneficiary, other than the employer;
   - c. A trust established for any such person; or
   - d. The insured's estate.
4. Death benefits received under an EOLI contract are used to purchase an ownership interest in the employer from any of the persons or parties set forth in c., above.

Whether or not an exception to the EOLI provision applies, the employer must still with the IRC Section 6039I reporting and recordkeeping requirements in order to avoid penalties. An employer must keep records and report the following: 1) the total number of employees; 2) the number of such employees insured under EOLI contracts; 3) the total amount of insurance in force under such contracts; 4) the name, address, and taxpayer ID of the policyholder and the business in which it is engaged; and 5) a statement that the applicable policyholder has a valid consent for each insured employee, or the number of insured employees from whom consent was not obtained. IRS has issued Form 8925 to be used for the reporting requirements on EOLI contracts, and it should be filed with the employer's tax return.

The broad reach of the new EOLI rules will affect a large number of business insurance arrangements. The exceptions explained above may allow such arrangements to avoid taxation, but only if the notice and consent requirements are observed ***before*** issuance of the contract. If an exception does not apply, the only current remedy is to cancel the original policy and have a new policy issued after satisfying the notice and consent requirements. This remedy could be problematic if the insured no longer qualifies for coverage, or the premiums for such coverage are significantly higher than under the prior policy. In any case, the reporting requirements of IRC Section 6039I will apply. For businesses with life insurance policies, it will be important to review application of all of the new provisions carefully.