

INSURING AN EMPLOYEE'S LIFE COULD NOW ENSURE AN INCOME TAX LIABILITY

By Carolyn Kershner

A new income tax law impacts any employer purchasing life insurance on an employee's life that is payable to the employer.

New General Rule: Ordinary income taxation of excess insurance proceeds (The new Internal Revenue Code Section 1010), enacted under the Pension Protection Act, provides that when an employer receives insurance proceeds from employer-owned life insurance ("EOLI") insuring the life of an employee, the employer is subject to tax, at ordinary income tax rates, on that portion of the insurance proceeds which exceeds the amounts paid by the employer for the policy.

Put more simply,

Ordinary income = EOLI proceeds - employer-paid premiums

This general rule applies regardless of the type of employer, size of employer, or reason for the insurance. It also applies if the policy is owned by a party that is considered to be related to the employer, e.g., a greater than 50% owner of the employer. Thus, the general rule applies to, among other things, split-dollar, deferred compensation financing, death-benefit only, key employee, cross-purchase, and buy-sell plans.

Exception: No income taxation if three requirements are met

The general rule requiring income taxation will not apply if (1)(a) the insured person falls into an enumerated category, or (b) the death benefits are payable to an enumerated category of persons, or (c) the death benefits are timely used to purchase an interest in the employer from an enumerated category of persons; and (2) the employer provides advance notice to the employee of its intent to obtain insurance; and (3) the employee consents in advance to the insurance.

(1)(a) Category of Insured. The first of the three requirements for the exception to taxation has been met if regardless of the named beneficiary or the use of death benefits, (i) the insured was an employee at any time during the 12-month period ending with the employee's death; or (ii) on the issue date of the policy, the insured was one of the following: (A) a director, or (B) an employee who was a 5% or greater owner of the employer at anytime during the current or prior year, or (C) an employee who received compensation in excess of \$95,000 (adjusted for inflation) in the prior year, or (D) one of the five highest paid officers of the employer, or (E) one of the employees that makes up the employer's highest-paid 35% of all employees.

(1)(b) Beneficiary of Death Benefits. The first of the three requirements for the exception to taxation has been met if, regardless of the category of the insured or use of death benefits, if the insurance proceeds are paid to (i) the insured's sibling (whole

or half blood), spouse, ancestor, or lineal descendant; or (ii) an individual (other than the employer) designated by the insured under the policy; or (iii) a trust established for any person described in (i) or (ii); or (iv) the insured's estate.

(1)(c) Use of Death Benefits. The first of the three requirements for the exception to taxation has been met, regardless of the category of the insured or the named beneficiary under the policy, if the insurance proceeds are used to purchase an interest in the employer from any of the parties described as a permissible beneficiary under (1)(b) Beneficiary of Death Benefits above. However, the payment for the purchase of the interest in the employer must be made by the due date of the policyholder's tax return for the taxable year in which the insurance proceeds are received. The purpose is to ensure that the payment to the seller of the interest in the employer occurs in the same year for which the income would otherwise be taxable under the general rule of Section 1010).

The purpose of mandating the Category of Insured, Beneficiary of Death Benefits, or Use of Death Benefits criteria is to ensure that the employer is not generating non-taxable revenue for itself by simply insuring ordinary, rank and file employees. If at least one of the Category of Insured, (1)(b) Beneficiary of Death Benefits, or Use of Death Benefits criteria is not met, the employer will recognize ordinary income. If any one of the three criteria is met, continue on to requirement (2) Notice to Employee.

(2) Notice to Employee. The second requirement for the exception to taxation is met if, before the policy is issued, the employer notifies the employee in writing that the employer intends to insure the employee's life and that the insurance proceeds will be payable to the employer. Further, the notice must state the maximum amount of coverage which could be obtained on the employee's life.

If the employer has not met the Notice requirement, the employer will recognize ordinary income. If the employer has met the Notice requirement, continue on to requirement (3) Consent of Employee.

(3) Consent of Employee. The third and final requirement for the exception to taxation is met if, before the policy is issued, the employee provides the employer with written consent to the purchase of the insurance and to the employer's continuance of the coverage after the employee's employment with the employer is terminated.

If the employer has not met the Consent requirement, the employer will recognize ordinary income. If the employer has met the Consent requirement in addition to the other two requirements for the exception to taxation, the excess insurance proceeds will not be includible in the gross income of the employer. However, note that the excess insurance proceeds may still be includible in gross income for purposes of the alternative minimum tax.

Reporting and Recordkeeping: File an annual information return with the IRS and be prepared to back it up

New Internal Revenue Code Section 6039I was enacted simultaneously with Section 101(j) and enumerates reporting and recordkeeping requirements for EOLI policies. First, the employer must file an annual return with the IRS that states (i) the employer's name, address, taxpayer identification number, and type of business, (ii) the total number of employees at the end of the year, (iii) the number of employees insured under EOLI policies at the end of the year, (iv) the total amount of insurance under those EOLI policies, (v) whether the employer has obtained a valid consent from each of the insureds, and (vi) the number of insureds for whom a valid consent was not obtained. Second, the employer must maintain records sufficient to determine whether the Section 101(j) income taxation rule, or the exclusion, applies.

Effective Date: New rules apply to EOLI policies issued on or after August 18, 2006

The new rules generally apply to any insurance policies issued, or substantially modified, after August 17, 2006. Exceptions include certain exchanges of contracts, changes to master contracts, administrative changes, changes resulting from application of Internal Revenue Code Section 7702, changes as a result of normal operation of an existing policy (e.g., automatic application of policyholder dividends to purchase paid-up additions), changes from a general to a separate account, or changes due to the exercise of an option granted under the previously issued policy.

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