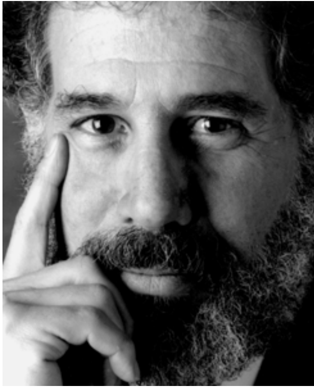

Leimberg's Think About It

Think About It is written by Stephan R. Leimberg, JD, CLU and edited by Eugenie DeRitter

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WHAT EVERY EMPLOYER'S ADVISOR NEEDS TO KNOW ABOUT NEW RULES IMPACTING ON EMPLOYER-OWNED LIFE INSURANCE

INTRODUCTION

Internal Revenue Code Section 101(j), added by the Pension Protection Act of 2006, imposes shocking and potentially devastating new tax treatment that impacts on every employer-owned life insurance policy issued after August 17th, 2006! Every employer and every employer's advisor needs to understand the broad scope and insidious reach of this law, which can easily turn income-tax-free life insurance proceeds into ordinary income!

ONE MORE TIME . . .

This new rule affects every type of business entity (C or S Corporation, LLC, Partnership, and even Sole Proprietorship) of every size (even one-person businesses) that, regardless of the reason or purpose, purchases insurance on an employee's life that is payable to the employer.

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BACKGROUND

EOLI's IMPORTANCE: Employer-owned life insurance (EOLI) has been an important and essential planning tool for businesses for many, many decades. It is used as an economic shock absorber to cushion the effect of the death of a key employee, fund a stock redemption buy-sell arrangement, finance (informally) an employer's obligation under nonqualified deferred compensation plans and death-benefit-only (survivor's income benefit) plans, as well as being a means of financing post-retirement employee benefits.

So, EOLI has long served businesses, employees, and their families in many creative, positive, legal, and ethical ways.

ABUSE OF A GOOD THING: During the late 1980s and in the following decade, promoters heavily marketed an abusive, broad-based tax leveraged product called Company Owned Life Insurance (COLI). Many well-known corporations such as Wal-Mart, Nestles, and Dow Chemical, as well as hundreds of lesser known but large publicly traded companies, purchased broad-based COLI policies on all, or almost all, of their full time employees rather than just key personnel—astoundingly, in many cases, without the consent or even knowledge of those insured!

The central purpose of these abusive COLI plans was to generate large annual income tax deductions though loans secured by the policies. The companies would own and name themselves as beneficiaries of the insurance contracts. Although the plans generally produced a negative effect on the company’s cash flow, when the interest deduction was factored in, these high-tax-bracket employers would experience a positive after-tax cash flow. At the death of an employee, the employer would receive income-tax-free proceeds.

When Congress limited the interest deduction to policy loans of $50,000 or less, insurance entrepreneurs marketed COLI policies that insured an even broader employee base, taking advantage of a nationwide trend of state laws recognizing an employer's insurable interest in lower-level employees. In most of these broad-based COLI plans, financial success depended not on economic gain from premature mortality of the insured employees but rather on the favorable tax treatment of cash value life insurance—that is, tax-exempt death benefits, tax deferral of inside buildup, and mainly, the deductibility of policy loan interest.

IRS AND COURTS STRIKE DOWN COLI PLAN: The IRS disallowed employer deductions for interest paid on the COLI policy loans on the basis that the policy loans, dividends, and partial withdrawals of policy cash value, which were used to pay premiums, lacked factual or economic substance and were sham transactions in fact. Or, taken as a whole, the plan had no practical economic consequences other than the creation of income tax benefits and, therefore, was a sham in substance. In every broad-based leveraged COLI case involving the exploitation of tax-arbitrage opportunities, the courts have eventually determined that the COLI plan(s) constituted economic shams, functioning only as interest-deduction engines that drove no legitimate financial vehicles.

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CLASS ACTION SUITS BY WIDOWS AND ESTATES: Almost simultaneously with the disastrously expensive and time-consuming court cases involving interest deduction disallowances on the grounds of a lack of substance and business purpose, class action suits began to arise against the same employers on the grounds that the employers lacked insurable interest. Plaintiffs in many of these cases successfully argued that the proceeds should be paid to the families or estates of the insureds rather than to the employers. (It is less likely that these suits would have arisen or would have been successful had the employers fully informed employees of what they intended to do and obtained their informed and voluntary consent to the insurance coverage, and then purchased an amount of insurance on each employee's life that was reasonably proportionate to the perceived potential employee benefit/retirement liabilities for that employee's class. But this was not done by most of the companies that instituted COLI plans. In one case, over $340,000 of insurance was owed by a music company on the life of a low-level record store employee!)

ACTION AND OVERREACTION: By 1996, legislation was enacted that effectively shut down further sales of these schemes. But the taint and stigma remained. Numerous front-page "Janitor's Insurance" and "Dead Peasant's Insurance" articles in the Wall Street Journal, New York Times, and other publications dealing with lawsuits brought by widows and estates of insureds impugning the abusive practices eventually triggered Capitol Hill reaction. The Senate Finance Committee held hearings on corporate-owned life insurance on October 23, 2003, during which time many of the more controversial issues were brought to light.

What resulted is clearly a congressional (over?) reaction to these headlines, as well as to numerous cases that involved the question of the extent of an employer's insurable interest in the lives of its employees as well as the policy owner's ability to deduct interest on so-called leveraged corporate-owned life insurance programs.

HOW THE NEW LAW IMPACTS EVERY EMPLOYER

GENERAL RULE: The general rule for life insurance is that the proceeds are income tax free if payable due to the insured's death. However, the new Code Section 101(j), which applies to all employer-owned life insurance ("EOLI") policies issued after August 17, 2006, [including bank-owned life insurance ("BOLI")] provides a very disconcerting and expensive exception to that general rule.

EXCEPTION FOR EOLI: Section 101(j) provides that, in the case of an employer-owned life insurance contract, the amount of the death benefit excluded from the "applicable policyholder's" income cannot exceed the premiums plus other amounts paid for the contract by such applicable policyholder.

Any proceeds received in excess of those two amounts are now taxable to the recipient employer at ordinary income rates!

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EOLI contracts are also now subject to reporting and record maintenance requirements under new Code Section 6039I. Those rules are discussed below.

GENERAL RULE FOR EOLI CONTRACTS

To summarize, when an employer receives death proceeds (directly or indirectly) from an employer-owned life insurance contract, life insurance proceeds will be ordinary income — except to the extent that the employer pays premiums and "other amounts"!

SAFE HARBORS

Fortunately, Congress provided certain narrow exceptions to this harsh rule of income inclusion. These safe harbor exceptions (which restore the income-tax-free character of life insurance proceeds) apply in the case of a life insurance contract if: (a) the "notice and consent" requirements of the new statutory provision are met and (b) the insured falls within a safe harbor class.

So, if both the notice and consent tests described below are met and the insured is a member of the safe harbor class, then employer-owned life insurance will be income tax free.

IN A NUTSHELL: The insured, to fall within the safe harbor class, must have been an individual who, with respect to the applicable policyholder:

1. Was an employee at some time during the 12-month period before the insured's death, or
2. Was, at the time the contract was issued, a director, a highly compensated employee, or a highly compensated individual.

If an insurance contract meets both the notice and consent requirements and the exception rules (generally designed to ensure that the coverage does not include rank-and-file workers), the full death benefit will be excluded from income for income-tax purposes.

EMPLOYEE NOTICE AND CONSENT REQUIREMENTS

THE THREE KEY ELEMENTS: BEFORE the issuance of a COLI contract:

1. The employee must be notified in writing that the employer intends to insure the employee's life. This notice must state (a) the maximum face amount for which the employee could be insured at the time the contract is issued and (b) that the employer may chose to retain the coverage after the employee no longer works for the employer for any reason; and
2. The employee must be informed in writing that the employer (technically the "applicable policyholder") will be a beneficiary of any death benefits; and
3. The employee must provide the employer with written consent to being insured under the contract and that the employer may continue the coverage after the employee terminates employment.

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SAFE HARBOR CLASSES: Assuming all three notice and consent requirements have been met before the issuance of the policy and if one or more of the following safe harbor exceptions apply, the death proceeds received by the employer from an EOLI contract will be income-tax free.

Recent Employee. Under this first safe harbor class, the insured must have been an employee of the employer at some time during the 12-month period before his or her death.

Insured was a director or highly compensated employee. Under this second safe harbor class, at the time the contract was issued, the insured must have been a director or a highly compensated employee or individual.

For purposes of this exception, such a person is one who is:

1. A highly compensated employee as defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20% of employees; or
2. A highly compensated individual as defined under the rules relating to self-insured medical reimbursement plans, determined by substituting the highest-paid 35% of employees for the highest-paid 25% of employees (certain employees are disregarded in making the determinations regarding the top-paid groups).

In other words, under this second safe harbor class, at the time the insurance coverage became effective (i.e., the issue date), the insured must have been:

1. A director, or
2. A 5% or greater owner of the business at any time during the preceding year, or
3. An individual who received compensation in excess of $105,000 in the preceding year (in 2008, adjusted in the future for inflation), or
4. One of the five highest-paid officers, or
5. Among the highest-paid 35% of all employees.

Death benefits paid to insured's heirs. Under this third safe harbor class, death benefits are income tax free to the extent paid to:

1. A member of the insured's family,
2. An individual who is the designated beneficiary of the insured under the contract (other than the employer),
3. A trust established for any family member or designated beneficiary (listed in #1 or #2 above), or
4. The insured's estate.

An "insured" is defined as a U.S. citizen or resident who is covered by the employer-owned life insurance contract. In the case of a joint-and-survivor contract, references to an insured encompass both individuals.

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This exception also includes life insurance death benefits used to purchase an interest (including partnership capital and profits) in the employer from any of the preceding persons or parties.

These amounts must be paid, or used, to purchase an interest in the employer by the due date of the tax return for the tax year of the applicable policyholder in which they are received as a death benefit under the insurance contract, so that the payment of the amount to such a person or persons, or the use of the amount to make such a purchase, is known in the taxable year for which the exception from the income inclusion rule is claimed.

REPORTING AND RECORD MAINTENANCE REQUIREMENTS

REPORTING: Employers who own one or more EOLI contracts issued after August 17, 2006, must file IRS Form 8925 with their tax return for each year the EOLI contracts are in force.

IRS Form 8925 requires the employer to specify:

- The number of employees at the end of the year;
- The number of those employees insured under the EOLI contracts at the end of the year;
- The total amount of insurance in force under the EOLI contracts at the end of the year;
- The employer's name, address, and taxpayer identification number ("TIN"), and the type of business of the employer, and
- That the employer has a valid consent (in accordance with the consent requirements) for each insured employee and the number of insured employees for whom such consent was not obtained.

RECORD KEEPING: Employers owning EOLI contracts subject to these rules must also maintain records necessary to determine whether the requirements of Code Section 101(j) are met.

WHEN DOES ALL OF THIS TAKE EFFECT?

EFFECTIVE NOW: These rules are already in effect! They generally apply to EOLI contracts issued after August 17, 2006, the date Pension Protection Act of 2006 was signed into law.

GRANDFATHERING: There is some limited grandfathering. These rules do not, however, apply to a contract issued after that date pursuant to a Code Section 1035 exchange for a contract issued on or before that date.

BEWARE: Certain material (a term as yet to be defined) increases in the death benefit or other material changes will cause the contract to be treated as a new (i.e., post-August 17, 2006) contract.

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EXCEPTIONS: There is an exception with respect to a master contract where the addition of covered lives is treated as a new contract only with respect to the additional covered lives. In this situation increases in the death benefit on existing lives under a master contract are not treated as material increases.

There is also an exception for certain other normal policy increases. None of the following will be treated as material increases triggering post August 17, 2006, treatment:

- Increases in the death benefit that occur as a result of the operation of Code Section 7702 (corridor or cash value tests).
- Increases due to the terms and normal operation of the existing contract (e.g., paid-up additions).
- Increases occurring as the result of market performance or contract design (provided that the insurer's consent to the increase is not required).

OTHER EXCEPTIONS: Certain other changes to a contract will not be considered material changes so as to cause a contract to be treated as a post August 17, 2006, contract. These safe harbor changes include:

- Administrative changes,
- Switches from a general to a separate account, or
- Changes that occur as a result of the exercise of an option or right granted under the contract as originally issued.

TAX TRAPS AND PLANNING TIPS

Here are some of the many tax traps practitioners need to be especially wary of:

NOTICE AND CONSENT: With respect to any EOLI policy issued after August 17, 2006, be sure you have documented that the employer provided sufficient and compliant notice to, and obtained written consents from, prospective insured employees BEFORE the policy was issued.

It is crucial to comply with the notice and consent rules, even if the insurance involved is designed to fund a stock redemption or provide reimbursement for an employer's loss on the death of a key employee, or will be used to informally finance an employer's obligation to fund a nonqualified deferred compensation or D.B.O. arrangement! There are no exceptions based on the purpose or "purity" of the employer's intent. Lack of abuse is irrelevant and there are no de minimus rules!

BEWARE: Some insurers have not changed their notice and consent forms to satisfy these new notice and consent rules—or may not have alerted agents and brokers of the importance of these new rules!

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WARNING: Check to make sure the notice and consent forms specifically state the maximum face amount for which the employee could be insured at the time the contract was issued. The use of the phrase "could be" raises issues for so-called aggregate-funded plans where the employer has an initial premium budget but has no idea if and when additional life insurance coverage might be needed to cover future benefit obligations.

WARNING: Even though this law was intended to thwart insurable interest abuses, it can easily ensnare seemingly benign common transactions. For instance, as a condition of extending credit, lenders frequently require businesses to obtain a life insurance policy on one or more key people in order to guarantee that the loan will be repaid. If a sole proprietor is required by a lender to purchase a $1,000,000 term policy to cover an outstanding loan, the requirements of Code Section 101(j) would seem to be triggered because the statute uses the term "employer-owned life insurance contract" and does not discriminate as to the size of the employer, the type of employer (e.g., C or S corporation, LLC, etc.), the face amount, the type of the policy, or the reason it was purchased.

CAN YOU FIX IT ONCE IT'S BROKEN?

What if the insured falls within one of the safe harbor classes described above but the timely notice and consent rules were not met? Is there a provision in the statute that allows innocent mistakes to be corrected?

The answer is currently "NO!" It appears the only way to "fix" the situation if you don't provide a timely notice and obtain consent before the policy is issued or, if either the notice or consent doesn't meet the Code Section 101(j) rules, is to surrender, lapse, or sell the insurance contract in question and start over. There are no provisions in the new law allowing corrective measures after the fact.

DEFINTIONS OVERLY BROAD AND POSE MAJOR TAX TRAPS!

EMPLOYER-OWNED LIFE INSURANCE CONTRACT: The term, "employer-owned life insurance contract" is very broadly defined. An "employer-owned life insurance contract" is a life insurance contract that

1. Is owned by a person engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary, and
2. Covers the life of an individual who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

Note the implication of the words "person" and "directly and indirectly."

INSURED DEFINED: The term "insured" is defined as an individual covered by the contract who is a U.S. citizen or resident. In the case of a contract covering the joint lives of two individuals, references to an insured include both of the individuals.

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APPLICABLE POLICYHOLDER DEFINED: The Code uses the term "applicable policyholder" to mean, with respect to an employer-owned life insurance contract, the person (including related persons) that owns the contract, if the person is engaged in a trade or business, and if the person (or a related person) is directly or indirectly a beneficiary under the contract.

RELATED PERSON DEFINED: A related person includes any person that bears a relationship specified in Code Sections 267(b) or 707(b)(1) or who is engaged in trades or businesses that are under "common control." In other words, related parties include specified relationships among family members, shareholders and corporations, corporations that are members of a controlled group, trust grantors and fiduciaries, tax-exempt organizations and persons that control such organizations, commonly controlled S corporations, partnerships and C corporations, estates and beneficiaries, commonly controlled partnerships, and partners and partnerships. Detailed rules apply to determine the specific relationships.

What this all means is that people or parties you might not expect to be considered employers may be so treated. And the related party provisions could end up bringing in some policies that may have little to do with employment for anyone who is deemed, either directly or by attribution, to own a controlling interest in a corporation that happens to employ someone that the person takes out insurance on—such as a spouse.

The reach of these rules is frighteningly broad and should not be underestimated by either insurance professionals or legal or accounting advisors!

CONCLUSION

The bottom line is that every member of the estate planning team must become hypersensitive to the potential tax traps of this new law. Every business, no matter what type or size, that (regardless of the reason) purchases any size or type of insurance policy on the life of any employee where the proceeds are payable directly or indirectly to the employer, must now comply with annual reporting and strict new initial notice and consent rules, and the party insured must fall within a specified exception class in order to retain the tax-free nature of the policy proceeds.

My advice is simple:

Until we have further guidance from the Treasury and IRS, it is essential to treat ANY AND EVERY new EOLI transaction as if it comes within the reach of Code Section 101(j) rules. If the employer is the owner and beneficiary of the contract, meet and document compliance with the notice and consent rules!

And make sure ALL the parties have copies of the employee-signed notice and consent statements and that they were signed BEFORE the issuance of the policy!!!!!

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