An Urgent Reminder About Employer-Owned Life Insurance

BY DOUGLAS I. FRIEDMAN

WITHOUT QUESTION, employer-owned life insurance rules are top-of-mind for discussion in 2008.

Here is the background: As a result of major companies buying insurance on low level employees—and apparently profiting from death proceeds while the employee's family had few financial resources—the Pension Protection Act of 2006 included so-called "janitor insurance" rules in its provisions, generally effective for policies issued after August 17, 2006.

Here is the problem: Even though the effective date was nearly 2 years ago, many agents are still not aware of these rules. Since failure to comply with the rules results in the life insurance proceeds being subject to income tax, this is not a good situation to be in.

Effective for life insurance policies issued after August 17, 2006 (with one exception, discussed below), all employer-owned life insurance (where the employer is a direct or indirect beneficiary) must meet new requirements for the death proceeds to be received income tax-free. If these requirements are not met, the proceeds will be taxable to the extent that they exceed the amount paid for the policy.

The first part of the requirements is the "notice and consent" rules. These require that the employee is notified, prior to policy issue, that the insurance is being purchased. The notice must also state the maximum face amount for which the employee may be insured at policy issue, and also state that the employer will be a death beneficiary.

The employee must consent in writing to being insured, and that the coverage may continue after termination of employment.

An insurance application itself is not sufficient to meet the notice and consent rules, as the requirements are broader than what is indicated in an insurance application.

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The second part of the requirements is met if the insured was either an employee during the 12-month period preceding death, or was a director or "highly compensated employee" when the insurance was purchased. Another way to meet this second part is to pay the proceeds to a member of the insured's family, a beneficiary designated by the employee (but not the employer), a trust for a family member or designated beneficiary, or the estate of the insured. Also, this second part is met if the proceeds are used to purchase the insured's equity interest in the business from specific sellers, such as a family member.

> **UNDER THE PPA**
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> *Source: summary by Douglas I. Friedman, Friedman & Downey, P.C., Birmingham, Ala.*

A section 1035 exchange on its own will not cause a contract to come under the new rules, but a material increase in death benefit or other material change in connection with the exchange will. The statute does not define material change. In fact, other than the definition of material change that is included in the modified endowment contract rules (promulgated in 1988), I am not aware of any definition for this term. So, to be safe, we've been recommending compliance with the notice and consent rules, even for 1035 exchanges.

Employers have reporting requirements associated with these rules. The Internal Revenue Service recently issued Form 8925 for employers to report whether they have employer-owned life insurance, and who is insured. The form also asks whether the notice and consent rules have been met.

Insurers have taken different approaches to these rules. Some apparently are requiring proof that the rules have been met before issuing a policy. Others are making sample forms available to agents, but without any requirements. Others have decided not to offer any forms or establish any requirements.

Each of these approaches is acceptable. The choice seems to depend upon the nature of the insurer's business, and its field force.

In any case, compliance with these rules involves interpretation of federal tax law, which is legal work. As with other aspects of insurance sales, it is the customer's responsibility to comply with the law. Of course, neither the agent nor the insurer should ever be giving legal advice.

One of the selling points of life insurance is that death benefits are typically income tax-free. So, agents should be aware of the rules and refer their customers to legal counsel for assistance in complying.

Many agents seem to be under the impression that these requirements can be cured retroactively. That is not the case. If the notice and consent rules are not met before policy issue, there is no way to cure the failure. While the hope is that Congress will act to provide a method of curing such failure, at present the only solution may be to reissue the policy and to provide the notice and consent before reissue.

This summary does not address all the related questions and complexities. For instance, do the rules apply to transactions beyond the janitor insurance originally targeted? And do key terms have specific meanings under the statute? These are all the more reason to consult legal counsel. NU

Douglas I. Friedman, a partner in the Friedman & Downey, P.C. law firm of Birmingham, Ala., is national counsel on estate and business planning for insurers. His e-mail is doug@fdatty.com.