

Getting it right: Protecting tax benefits of employer-owned life insurance policies

The consequences for failing to comply with the rules surrounding employer-owned life insurance contracts are harsh.

The tax rules were



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changed for contracts issued after Aug. 17, 2006, so if you have not changed or entered into an employer-owned life insurance contract since then, you may not be aware of the new requirements.

Certain policy proceeds that are normally tax-free can become taxable if proper procedures are not followed. Losing these tax benefits can be costly, but can also be avoided by following certain notification, consent and reporting procedures.

It is important to comply with the rules now to properly preserve the tax benefits of proceeds you may collect later. If you

plan on entering into any new contract, the time to act is before the policy is issued and at tax reporting time for each year that the policy is in effect.

Employer-owned life insurance (EOLI) contracts are policies owned by a business that cover individuals, who at the time the policy was issued, worked for the company. The other key characteristic of an EOLI contract is that the business is the beneficiary of the policy.

Often times these are referred to as “key-man” policies and are purchased to indemnify the business for the loss of a key employee. They can also be a key ingredient in a buy-sell agreement by serving to fund the buyout of a deceased shareholder or partner by the surviving partners or shareholders.

What are the consequences of not following the rules?

The tax code does not allow the deductibility of premiums paid for employer-owned life insurance contracts, and

historically it also allowed businesses to exclude death benefit proceeds from income when collecting on the contracts.

In 2006 a rule was placed into effect whereby the income exclusion is limited to an amount equal to the premiums paid for the policy, unless certain requirements are met.

Policies that were in place before Aug. 17, 2006, are not affected by the new rules unless they’re modified after that date.

There are three steps in meeting the requirements: notification, consent and reporting. If the requirements are not met, the only portion that may be excluded from income is that amount of death benefits equal to the sum of premiums and other amounts paid by the policyholder for the contract.

Notification and consent

For policies issued after Aug. 17, 2006, the exclusion of death benefit pay-

ments from income will only be allowed for those employers who provide notification and obtain consent from the party they wish to insure. The notification and consent must be in writing and must contain all of the following information.

- Provide the employee with notice of intent to insure the employee’s life as well as the maximum face amount for which the employee could be insured at the time the contract is issued. The face amount must be in dollars or as a multiple of salary.

- The notice must state that the employer will be the beneficiary of any proceeds payable upon the death of the employee.

- The employer must also obtain written consent from the employee and consent to have coverage that may extend after the employee terminates employment.

For the consent to be valid, the EOLI contract must be issued within a year after the consent

was executed or before the employee terminates employment, whichever is earlier.

A new notice and consent needs to be issued and obtained if the aggregate face amount of the policy is increased to exceed the amount listed on the original notice and consent.

Reporting
Additionally, the new rules also require policyholders who own one or more EOLI contracts to report information about them annually. Form 8925 was developed by the Internal Revenue Service to satisfy the reporting requirements and needs to be included with the tax return of any business that owns EOLI contracts.

The reporting stipulation requires the employer to disclose the total number of employees, the number of employees insured under EOLI contracts issued after Aug. 17, 2006, and the amount of EOLI insurance in force at the end of the tax year.

The form also requires the employer to report whether they have obtained a valid consent from the employee.

There has been no change in the tax treatment of any interest included in the insurance proceeds. Interest that accrues between the date of death and the date the benefit is paid remains subject to income tax.

If you already have employer-owned life insurance contracts, make sure you inform your tax professional, and if you plan on entering into any new contract or modifying any existing contracts, consult your insurance and tax professional to make sure you are complying with the new rules regarding notice, consent and reporting.

It can save you from a costly tax consequence.

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