

GOLDENBULLETS

Ryan M. Wilson
Fraser Trebilcock Davis & Dunlap, P.C./Lawyers
124 West Allegan Street, Suite 1000
Lansing, MI 48933
Telephone: (517) 377-0897
Fax: (517) 482-0887
Email: rwilson@fraserlawfirm.com

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WHAT EVERY EMPLOYER NEEDS TO KNOW ABOUT NEW EMPLOYER-OWNED LIFE INSURANCE RULES!

Every employer must understand the incredibly broad scope and insidious reach of a recently enacted law.

WHAT: Code Section 101(j), added by the Pension Protection Act of 2006, imposes shocking and potentially devastating new tax treatment that can transform income tax-free life insurance proceeds into ordinary income!

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

WHEN: These rules are already effective! They generally apply to employer-owned life insurance (EOLI) contracts issued after August 17, 2006.

IMPORTANCE: Employer-owned life insurance (EOLI) has been an important and essential tool for businesses for many decades. It is used as an economic shock absorber to cushion the death of a key employee, fund a stock redemption buy-sell agreement, finance an employer's obligation under nonqualified deferred-compensation plans and death-benefit only (survivor's income benefit) plans, and as a means of financing post-retirement employee benefits. So EOLI has long served businesses, employees, and their families in many creative and positive ways.

GENERAL RULE: Although the general rule for life insurance is still that the proceeds are income tax-free if payable by reason of the insured's death, new Code Section 101(j), which applies to all employer-owned life insurance policies issued after August 17, 2006 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 excluded from the “applicable policyholder’s” income as a death benefit cannot exceed the premiums and other amounts paid by the employer. Any proceeds received in excess of those two amounts are now taxable to the recipient employer at ordinary income rates!

SAFE HARBORS: Fortunately, Congress provided 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 the “notice and consent” requirements of the new statutory provision are met and the insured falls within a safe harbor class.

REPORTING: Employers who own one or more EOLI contracts issued after August 17, 2006 must file an annual IRS return. The employer’s report must specify the number of employees at year end; the number of those employees insured under EOLI contracts at the end of the year; the total amount of insurance in force under EOLI contracts at year end; the employer’s name, address and taxpayer identification number (“TIN”), the type of business, and that the employer has a valid consent (in accordance with the consent requirements) from each insured employee and the number of insured employees for whom no such consent was 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.

CONCLUSION: Every business, no matter what type or size, that (regardless of the reason) purchases any size or type 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 the specified excepted class in order to retain the tax-free nature of the policy proceeds.

AS ALWAYS, PLEASE FEEL FREE TO CALL TO DISCUSS THESE AND OTHER ISSUES OF IMPORTANCE.

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“Golden Bullets” is provided as a source of general information about current developments in the practice of estate planning and related topics. If you have questions regarding this issue or estate planning in general, please contact me prior to taking action.

Ryan M. Wilson (517) 377-0897
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