

Understanding the Rules

Employer-Owned Life Insurance

The Rules ...

- **The Law: Pension Protection Act of 2006**
- **Effective Date: August 18, 2006**
- **General Rule: Death benefits paid from “employer-owned life insurance” (EOLI) contracts will be taxed as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer.**
- **Rules Also Provide: If certain notice and consent requirements are met in a timely manner, and certain safe-harbor rules apply, death benefits still pass income tax-free.**

Just What Is an “Employer-Owned” Life Insurance Contract?

- Owned by a person engaged in a trade or business – the “applicable policyholder”
- Under which, such applicable policyholder or “related person” is directly or indirectly a beneficiary, and
- Where the insured is an employee of the trade or business of the applicable policyholder on the date the policy is issued

Just What Is an “Employer-Owned” Life Insurance Contract?

- **Covers common business arrangements where a trade or business is the owner and directly or indirectly a beneficiary. Including:**
 - **Key Person Coverage**
 - **Business Debt Liquidation**
 - **Deferred Compensation/SERP Arrangements**
 - **Entity Purchase Buy-Sell Arrangements**
- **But Goes Much Further**

Who Is an Applicable Policyholder?

- **Applicable Policyholder:**
 - Includes the trade or business that owns the contract
 - Also includes “related parties” bearing certain relationships to the employer-owned policy

Who Is a “Related Party”?

- “Related Party” as defined for the applicable policyholder rules includes the relationships described under:
 - IRC § 267(b), the **constructive ownership** rules
 - IRC § 707(b)(1), dealing with **transactions between a partner and a partnership**, and
 - IRC § 52(a),(b), the **common control rules** applicable to corporations.

Could These Rules Apply to an Endorsement Split Dollar Arrangement?

- **The Scenario:** An endorsement split dollar arrangement is set up with business owning the policy and a family member endorsed as the beneficiary.
- **Related-Party Rules:** Under the **constructive ownership** rules, “family members” are related parties.
- **The Result:** *It appears these policies could be considered employer-owned contracts and the potential for taxable death benefits exists unless the EOLI rules are followed.*

Additional Guidance Concerning Application of EOLI Rules

- Notice 2009-48 provided some clarification regarding what contracts are subject to the EOLI rules
- Person **owning the contract must be engaged in a trade or business**. The following are not subject to EOLI rules
 - Contracts owned by qualified plans and VEBAs that are sponsored by an entity engaged in a trade or business
 - Contract owned by the owner of an entity engaged in a trade or business
 - Contract owned by a sole proprietor on his/her own life
- Contracts **owned by a grantor trust** of an entity that is engaged in a trade or business is subject to EOLI
 - Rabbi trusts in deferred compensation/SERP arrangements

Notice and Consent Requirements

- Must be completed prior to contract issue
- The applicable policyholder must give written notification to the employee:
 - Of the **intention to insure the employee's life,**
 - Specifying the **maximum face amount** of the intended coverage at the time of issue, and
 - Specifying that the **applicable policyholder will be the beneficiary of any death benefits paid.**
- The employee must give written consent:
 - Indicating awareness of the coverage and that such coverage may extend beyond the termination of his or her employment.

When Is a Contract Deemed Issued?

- The notice and consent requirement **must be met before contract is considered issued**. A contract is considered issued at the **later of**:
 - Date of application of coverage
 - Effective date of coverage
 - Formal issuance of the contract
- For the notice and consent to be effective the contract must be issued before the **earlier of**:
 - Expiration of one-year period beginning on the date the consent was executed
 - Termination of the employee's employment with respect to the trade of business of the applicable policy holder

Can an Inadvertent Notice and Consent Failure Be Corrected?

- **The IRS will not challenge the application of a safe harbor because of an inadvertent notice and consent failure where the:**
 - **applicable policy holder made good faith attempt to satisfy the requirements by maintaining a formal system,**
 - **the failure to satisfy the requirements was inadvertent, and**
 - **the failure was discovered and corrected no later than the due date of the tax return for the tax year in which the policy was issued.**

Safe Harbor: Based on Insured's Status

- The income inclusion rule does not apply **if the notice and consent requirements have been met** and the insured individual was either:
 - An employee at any time during **the 12-month period before the insured's death, or**
 - A **director, a highly compensated employee, or a highly compensated individual** at the time the contract was issued.

Definition: Highly Compensated Employees

- **Defined under IRC § 414(q)**
- **Includes employees:**
 - **Who were 5% owners of the business during the preceding year, or**
 - **Had compensation in excess of a specified dollar amount.**
- **Employees include:**
 - **Self-employed individuals**
 - **Independent contractors**
 - **Former employees**

Definition: Highly Compensated Individuals

- **Defined under IRC § 105(h)(5)**
- **Includes:**
 - **The five highest-paid officers**
 - **Those individuals among the highest paid 35% of all employees**

Safe Harbor: Based on Who Receives the Death Benefits

- The income inclusion rule does not apply **if the notice and consent requirements have been met**, to the extent policy proceeds are paid:
 - To a family member,
 - To an individual who is the designated beneficiary of the insured (other than an applicable policyholder),
 - To a trust established for the benefit of any such member of the family or designated beneficiary,
 - To the estate of the insured, or
 - Where policy proceeds are used to purchase an equity interest in the applicable policyholder.

Reporting & Record Maintenance Requirements

- **Applicable policyholders must file a report with the IRS for each year employer-owned contracts are owned.**
- **The report must include:**
 - **The name, address, and taxpayer identification number of the applicable policyholder as well as the type of business.**
 - **Indicate at year-end:**
 - **The total number of employees**
 - **The number of employees insured**
 - **The total amount of insurance in force**

Reporting & Record Maintenance Requirements

- **Attestation that valid consent was received from the insured employees**
- **Where consent was not obtained, the number of insured employees for whom such consent was not obtained**
- **Records must be kept for any year employer-owned contracts exist**

Will a Section 1035 Exchange of an Old Policy Cause It To Be Subject to EOLI?

- For policies issued **before** August 17, 2006, that are **exchanged after** that date, the EOLI rules do **not apply** as long as there is **no increase in death benefit** or other **material change** as a result of the Section 1035 exchange.
- What's a material change?

How Can an EOLI Error Be Corrected?

- **Start over with new policy**
- **A material change to an existing policy will cause it to be considered a new policy. As long as the EOLI requirements are met before the new policy is issued the new policy can avoid the adverse tax results of an EOLI contract.**
 - **Section 1035 to a larger face amount or other material modification**

In Summary

- **The new rules do not rule out income tax-free death benefits for employer-owned insurance where:**
 - **Specific notice and consent requirements are timely met,**
 - **The policies qualify for a safe harbor because of who they cover or who receives the policy proceeds, and**
 - **The applicable policy holder meets IRS reporting requirements and maintains proper documentation that the new rules have been met.**

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