

Policy Review Opportunity

Are Your Business Policies Subject to Taxation? If you have:

Now

- ✓ Life insurance policies issued after August 17, 2006, where the
- ✓ Business is owner of the policy and the business or related party is the beneficiary of a policy on the life of an employee (i.e., key person, debt liquidation, buy-sell, endorsement split dollar, nonqualified deferred compensation/SERP), and an
- ✓ Employee notice and consent was **not** completed before policy issue.

The death benefit is subject to income tax under IRC §101(j).

Recent notice provides opportunity to correct IRC §101(j) tax.

When the employer-owned life insurance legislation under IRC §101(j) was enacted in 2006, advisors believed the only way to correct a situation where the above conditions existed was to surrender the contract and reissue a new contract after proper notice and consent had been obtained.

However, a recent IRS notice provides another option which means an opportunity for you. **A Section 1035 exchange to a new policy with a larger face amount or other material change is deemed a new contract, on which proper notice and consent can be obtained before issue.**

Review Business Cases Today

Life Insurance issued by The Prudential Insurance Company of America and its affiliates.

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Prudential

ATTENTION EMPLOYERS

Employer-Owned Life Insurance Rules Have Changed

Are you thinking about purchasing key person life insurance on yourself or one of your employees to help indemnify the business against financial loss in the event of one of your deaths? Perhaps you are considering the purchase of life insurance to assist in financing the cost of employee benefit plans or to help fund the purchase of a business interest under the terms of a buy-sell agreement. If so, you will want to take time to read this flyer because the rules have changed.

How Have the Rules Changed for Employer-Owned Life Insurance?

For *employer-owned contracts* issued after August 17, 2006, the Pension Protection Act generally provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met and certain exceptions apply, death proceeds can be received income tax-free.

What is an Employer-Owned Contract?

The starting point to understanding the impact of the legislation is to recognize what it calls an *employer-owned contract*. An employer-owned contract is defined as a life insurance contract

- That is owned by a person engaged in a trade or business (*applicable policyholder*, as defined by the law)
- Under which such person, or related person (as defined by the law), is directly or indirectly a beneficiary, and
- That covers an insured that is an employee of the trade or business of the applicable policyholder on the date the contract is issued.

Clearly this definition includes policies where a business is the owner and beneficiary. What's

not so obvious is that, under the *applicable policyholder* and *related party* definitions, the legislation expands its reach to a broad group of individuals and entities such as family members, trusts, and estates.

Notice and Consent Required Prior to Issue

Congress apparently was aware that this broad definition could negatively impact many valid business uses, so it included a number of exceptions in the legislation. However, the exceptions only apply where the employee receives **notice of, and consents to, the following in writing prior to policy issue:**

- The applicable policyholder intends to insure the employee's life and specifies the maximum face amount for which the employee will be insured at time of issue;
- The employee consents to being insured and agrees that such coverage may continue after he/she terminates employment; and
- The applicable policyholder will be the beneficiary of the death proceeds paid.

Meeting the notice and consent requirements is a critical first step to avoiding taxation of death benefits applicable to employer-owned contracts. However, notice and consent is not the only requirement imposed by the legislation. Employer-owned contracts must also fall within one of the following exceptions.

Exception: Based on an Insured's Status

This exception provides that the income inclusion rule will not apply to employer-owned contracts provided the insured was either:

- An employee at any time during the 12-month period prior to death, or



- A director, a *highly compensated employee*¹, or a *highly compensated individual*² at the time the contract was issued.

Exception: Based on Who Receives the Death Benefit Proceeds

This exception states that the income inclusion rule will not apply to an amount received at the death of an insured to the extent the amount is paid:

- To a family member of the insured;
- To an individual, other than an applicable policyholder, who is the designated beneficiary of the insured;
- To a trust established for the benefit of a family member or designated beneficiary;
- To the estate of the insured; or
- Where the policy proceeds are used to purchase an interest in the applicable policyholder from such family member, beneficiary, trust, or estate.

Reporting & Record Keeping Requirements

The legislation also mandates annual reporting of employer-owned contracts for each year the contracts are owned. This reporting is provided on IRS Form 8925 and attached to the policyholder's tax return. Form 8925 requires the following:

- The number of employees at the end of the year;
- The number of employees insured under such contracts;
- The total amount of insurance in force under such contracts;
- The name, address, taxpayer identification number of the applicable policyholder as well as the type of business; and
- An attestation that valid consent has been obtained from each insured, or where all consents have not been obtained, the number of insureds for whom such consent was not obtained.

In light of these reporting rules, it's extremely important that you maintain documentation that proves that you have met the notice and consent requirements in a timely manner.

Remember

Life insurance policies can still provide income-tax-free death benefits to help you meet your business goals, but the key to a successful plan is following the rules.

In light of the broad application of this legislation it is important that you understand these rules prior to entering into a transaction involving an employer-owned life insurance contract.

¹ *Highly compensated employees include employees who were 5% owners of the business at any time during the preceding year or who received compensation in excess of a specific amount during the preceding year (\$105,000 if the preceding year is 2007, \$110,000 if the preceding year is 2008, indexed for inflation in future years).*

² *Highly compensated individuals include the five highest-paid officers or individuals who are among the highest-paid 35% of all employees.*

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A sample generic Acknowledgment and Consent to Employer-Owned Life Insurance form appears below. Please be aware that this form has not been adapted to the specific circumstances or objectives of an individual employer. Neither The Prudential Insurance Company of America nor its representatives provide tax or legal advice. We strongly urge you to consult with your attorney to understand the application of these rules to your situation prior to completing an employer-owned life insurance transaction.

Sample Acknowledgment and Consent to Employer-Owned Life Insurance

Proposed Insured Name: _____

Employer/Applicable Policyholder Name: _____

Employer/Applicable Policyholder Address: _____

Employee Acknowledgment and Consent

The employer/applicable policyholder has given me notice that it intends to purchase a life insurance policy or policies on my life. I understand and consent to the following:

- I will be the insured under the policy(ies).
- The employer/applicable policyholder will own the policy.
- The employer/applicable policyholder may, directly or indirectly, be a beneficiary of the policy(ies) and may receive proceeds payable on my death.
- The employer/applicable policyholder, or its successors, may continue to be the owner and/or may be a beneficiary of the policy even after my employment terminates.
- \$_____ is the maximum face amount for which I may be insured by the employer/applicable policyholder at time of issue.

X

Signature of the Proposed Insured

Date

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Death Proceeds on Employer-Owned Life Insurance Subject to Taxation

Question: I have heard that tax legislation made *employer-owned* life insurance taxable. Would you help clarify this and explain what impact this legislation has on common business uses of life insurance such as deferred compensation arrangements, key person coverage, and buy-sell arrangements?

Answer: Provisions of the Pension Protection Act of 2006 state that for *employer-owned contracts* issued after August 17, 2006, death benefits will be taxed as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer.¹

At first glance, the legislation seems to negatively impact many business uses of life insurance. Fortunately, the rules also provide that if certain notice and consent requirements are met and if certain exceptions apply, death benefits will still pass income tax-free.

Thus, the key to avoiding taxation of employer-owned life insurance death benefits is to follow the rules. Let's start by looking at the definitions.

Employer-Owned Contract. The Pension Protection Act defines an *employer-owned contract* as a life insurance contract:

- That is owned by a person engaged in a trade or business (*applicable policyholder*, as defined by law)
- Under which, the applicable policyholder, or related person (as defined by the law), is directly or indirectly a beneficiary, and
- That covers an insured who is an employee of the trade or business of the applicable

policyholder on the date the contract is issued.

Clearly, this definition includes policies where a business is the owner and beneficiary. What's not so obvious is that under the *applicable policyholder* and *related party* definitions, the legislation expands its reach to a broad group of individuals and entities such as family members, trusts, and estates.

Applicable Policyholder and Related Party.

As defined, the term *applicable policyholder* includes a trade or business that owns the contract but also includes any individual who bears a relationship to the applicable policyholder if that relationship is described under any of the following sets of *related party* rules:

- IRC § 267(b), the constructive ownership rules,
- IRC § 707(b)(1), dealing with transactions between a partner and a partnership, or
- IRC §52(a), (b), the common control rules applicable to corporations.

The related party provision is important since it broadens the reach of the rules beyond policies owned by a trade or business. The question is how far was it meant to reach?

Fortunately, in Notice 2009-48, the IRS clarified that to be an employer-owned contract the person owning the policy must be engaged in a trade or business. Consequently, contracts owned by qualified plans or a VEBA that is sponsored by an entity engaged in a trade or business is not subject to the EOLI rules. Likewise, contracts owned by the owner of an entity engaged in a trade or business is not

¹IRC § 101(j)



subject to the EOLI rules. However, a contract that is owned by a grantor trust the assets which are treated as assets of a grantor that is engaged in a trade or business may be an employer-owned contract – think Rabbi trust.

In light of the broad reach of these rules, it is important that business owners work with their tax and legal counsel to see if any of the *related party* rules are applicable prior to implementing and placing a life insurance policy on an employee.

Notice and Consent Requirements. Congress apparently was aware that the broad definitions of the terms, *employer-owned contract*, *applicable policyholder*, and *related party* could negatively impact many valid business uses, so it included a number of exceptions. However, the exceptions apply only if the employee receives specific **notice and consent in writing prior to policy issue**. Meeting the notice and consent requirements is a critical first step to avoiding taxation of death benefits applicable to employer-owned contracts.

Under the notice and consent rules, the following actions must be taken by an applicable policyholder before a life insurance contract is issued:

- The employee must receive written notification of the applicable policyholder's intention to insure the employee's life, and such notification must specify the maximum face amount for which the employee could be insured at time of issue;
- The employee must provide written consent that he or she is aware of the insurance coverage and that the coverage may continue after he or she terminates employment; and
- The applicable policyholder must inform the employee in writing that the policyholder will

be the beneficiary of any death benefits paid.²

Failure to meet the notice and consent requirements prior to policy issue will result in the death benefits being subject to ordinary income tax. When is a policy considered issued?

When the law was first established it did not contain a definition of when a contract was considered issued. Notice 2009-48 provided the following explanation. For purposes of determining whether the notice and consent are timely "issue" is considered the later of:

- Date of application of coverage,
- Effective date of coverage, or
- Formal issuance of the contract.

Proper notice and consent is not the only requirement imposed by the legislation. As indicated earlier, to avoid being subject to income taxation, employer-owned contracts must also meet the terms of one of the following exceptions.

Exception Based on an Insured's Status.

This exception provides that the income inclusion rule will not apply to employer-owned life insurance provided that proper notice and consent is given 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**.

² Note: To help our customers comply with these new requirements, Prudential has developed a sample Notice and Acknowledgement of Consent to Insurance document found in ATTENTION EMPLOYERS – Employer-Owned Life Insurance Rules Have Changed – 0150882-00001-00.

Highly compensated employees are defined using the rules found in IRC § 414(q) and include employees who, during the preceding year, were 5% owners of the business or had compensation in excess of a specified dollar amount (\$105,000 for 2008, \$110,000 for 2009, increased for inflation in future years).

Note: Because of the reference to IRC § 414(q) and wording in that Internal Revenue Code section, employees include independent contractors, self employed individuals and former employees.

Highly compensated individuals are defined under IRC § 105(h)(5) to include the five highest-paid officers or to be among the highest paid 35 percent of all employees.³

Exception Based on the Individuals Who Receive the Death Benefit Proceeds. This exception states that, provided proper notice and consent is given, the income inclusion rule will not apply to an amount received at the death of an insured to the extent the amount is paid:

- To a family member of the insured,
- To an individual, other than an applicable policyholder, who is the designated beneficiary of the insured,
- 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 the policy proceeds are used to purchase an interest in the applicable policyholder from such family member, beneficiary, trust, or estate.

Finally, the legislation mandated annual reporting. The IRS has provided Form 8925 for this purpose.

Reporting and Record Maintenance Requirements. Under the new rules, applicable

³ Note that 35% has been substituted for the 25% generally applicable under IRC § 105(h)(5).

policyholders who have employer-owned contracts are required to file Form 8925 with the Internal Revenue Service (IRS) for each year the contracts are owned. Form 8925 requires the following information:

- The number of employees the policyholder had at the end of the year;
- The number of those employees who were insured under such contracts at the end of the year;
- The total amount of employer-owned insurance in force at the end of the tax year under such contracts;
- The name, address, taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged; and
- Attestation that the applicable policyholder has obtained valid consent from each insured, or where all consents are not obtained, the number of insureds from whom such consent was not obtained.

In light of these reporting rules, it is extremely important that applicable policyholders maintain records documenting that they have timely met the notice and consent requirement.

Effective Date of the New Rules. These rules took effect for contracts issued after August 17, 2006, the date of enactment of the Pension Protection Act.

The rules do not apply to a like-kind IRC § 1035 exchange of a contract issued on or before August 17, 2006, and Form 8925 is not required for such a change. However, any material increase in the death benefit or material change will cause the contract to be treated as a new contract (except with respect to a master contract, where the addition of covered lives is treated as a new contract only with respect to the added lives).

Because of the uncertainty about what is considered a *material change*, fewer IRC § 1035

exchanges than originally thought may be grandfathered.

Notice 2009-48 sheds some light on the subject by stating that none of the following will be considered a *material change*:

- Administrative changes
- Changes from general to separate account
- Changes resulting from the exercise of an option or right granted under the contract as originally issued
- Increases in the death benefit occurring as a result of the operation of IRC § 7702

The Notice does not address many other situations. For example, is a carrier change considered a *material change*?

Correcting a Violation. Initially, most advisors believed that once the employer-owned life insurance rules were violated there was no means to correct the situation other than to start over. However, in Notice 2009-48 the IRS indicated that by doing a Section 1035 exchange to a larger face amount (or other material modification), it's possible to correct a violation by complying with the rules prior to the issue of the new policy.

In Summary. The employer-owned life insurance rules have not ruled out income tax-free death benefits where a life insurance policy is owned by a business; however, specific requirements must be met. Specifically, the employer must now meet notice and consent requirements prior to policy issue; file Form 8925 annually with the IRS when such policies are in place; and limit coverage to certain individuals or restrict who receives policy benefits.

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