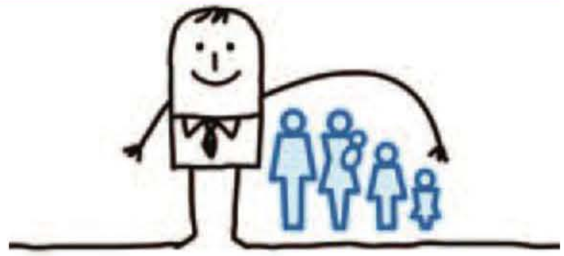
By Robert M. Barnes, CLU, ChFC, CWPP



Understanding the Tax Impact of Employer-Owned Life Insurance

Are you aware of the insurance regulations that went into effect in August 2006? Don't be afraid to say "no," as you certainly are not the only financial advisor who is unfamiliar with these important rules. And it's not just advisors—insurance agents, attorneys, and accountants might be overlooking them, too. Yet not complying with the rules could cost your client a great deal of money by making the receipt of a life insurance benefit a taxable event.

Federal rules for employer-owned life insurance (EOLI) can be found in the Internal Revenue Code, Section 101(j), which was finalized in 2006. It outlines when EOLI benefits would be taxed, and when they would be eligible for tax-free distribution just like other life insurance benefits. The rule also defines what a business owner must do to earn the tax-exempt status. Basically, if a business owner purchased a policy after Aug. 17, 2006, he or she is required to document, disclose, and report the purchase. If the disclosure rules (explained below) are not met, the death benefit will not be exempt from taxation.

How did we get here? In the 1980s and '90s, a large number of employers, including Wal-Mart, purchased life insurance on most, or all, of their employees (hence the policies' nickname of "janitor insurance"). The companies were the beneficiaries of the policies. They borrowed money to purchase the policies and deducted interest on the loans. It was easy money.

Lawsuits were filed and won by certain front-line employees who argued that they lacked insurable interest, especially if the policies were maintained after they left their employer. Some companies were required to pay the life proceeds to the deceased employees' families, and some settlements included additional penalties.

In the aftermath, laws were put in place to regulate EOLI transactions. The regulations now include definitions of insurable interest and other minimum requirements that are necessary for employers to insure an employee while maintaining a tax-free benefit status.

The Rules

Under current law, a transaction as simple as a sole owner of an S-corporation buying "key man" coverage on his life will trigger compliance requirements. Even when the insurance purchase does qualify under IRC Section 101(j), a business owner might find that owning insurance individually will be easier.

Complying with the EOLI rules and guidelines begins by understanding the three-step notice and consent requirements:

- *Disclosure*. The employee must receive notice that the employer will be purchasing life insurance and will be the primary beneficiary of the policy. The notice must also identify the maximum amount of coverage to be placed on the employee.
- *Documentation*. The employee must agree in writing to be insured and to allow the employer to retain coverage beyond his employment era.
- *Reporting*. The employer must file IRS Form 8925 annually.

One more important point: EOLI death benefits are taxable to the extent the death benefit exceeds premiums paid. However, the death benefit becomes tax-free if the employer complies with the EOLI notice, consent, and reporting requirements of Section 101(j), AND if the employee fits one of the safe harbor rules created by this legislation. Here are the four safe harbors:

- The insured is a highly compensated employee who fits into at least one of the following categories:
  - A director,
  - A five-percent or greater owner,
  - Received compensation in excess of $115,000 in 2012 (adjusts for inflation),
  - One of the five highest-paid officers, or among the highest-paid 35 percent of all employees.
- The insured is an employee within one year of death.
- The death benefit is paid to the insured's personal beneficiary, which can include: a member of the insured's immediate family; a trust for which the insured is a beneficiary; or the estate of the insured.
- The proceeds are used to purchase an interest in the business.

It is also important to mention that a "material change" to a policy purchased prior to implementation of the regulations could trigger the need to comply with the EOLI requirements as a "new" contract. Furthermore, the employee's consent must be made before the policy is "issued." In 2009, the IRS published Notice 2009-48, which further defined the term "issued" as the later of: 1) the date of application for coverage; 2) the effective date of coverage; or 3) the date of formal issuance of the contract.

As with many laws that are relatively new, this one has not been extensively

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tested in the court system, so there are still some uncertainties about who is affected. From the perspective of a business owner, the specific definition of "material change" could be better-defined. Also, there appears to be no method of "fixing" a violation if an employer failed to comply on purchases or material changes made after Aug. 17, 2006. Interpretations of the law indicate that an employer might be able to rewrite the coverage if it's a term policy, or perhaps use a 1035 exchange with a larger death benefit if permanent insurance is involved. However, these areas could use more clarity, even though the IRS issued its interpretation guidelines in 2009.

IMPACT ON ADVISORS

The question a financial advisor needs to answer is: What is my professional obligation in EOLI transactions? Best practices suggest that advisors working with business owners need to report the details to both the individual's attorney and accountant, as well as to the attorney, accountant, and CFO of the business (depending on the size of the business). The attorney (not the advisor) should draft the consent form, and the accountant is required to file the IRS Form 8925.

One way that an advisor can facilitate the process is to develop an EOLI kit, and my firm has developed such a checklist. I send my EOLI kit by e-mail to all relevant parties involved with a reply-request to confirm their receipt and acknowledgement of the information. (For a copy of the kit, send an e-mail to Robert Barnes at rob@intinsconsulting.com, with "EOLI Kit" in the subject line.)

While getting involved in EOLI notification does create some complications for advisors, the upside is worth the effort. It's an opportunity to create new relationships by calling a client's attorney and accountant. It's an opportunity to show a client that the advisor is on top of important issues and that he or she can work with the rest of the client's financial and legal team. Finally, it's important that the advisor work with an insurance partner to provide all of the facts about clients who are business owners, in order to assure a client's needs are being met and that everyone is in compliance with the law.

Robert M. Barnes, CLU, ChFC, CWPP, is president of Integrated Insurance Consulting, LLC, a NAPFA Resource Partner. He specializes in the use of life insurance for business and estate planning. He can be reached at 708.307.2577 or Rob@intinsconsulting.com.