Tax Law Information Memo

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Electronic Dispatch

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TAX LAW CHANGE AFFECTS TAXATION OF PROCEEDS FROM EMPLOYER-OWNED LIFE INSURANCE

The Pension Protection Act of 2006 (the "Act") changes the tax treatment of the death proceeds of certain employer-owned life insurance on the lives of employees and former employees.

Historically, life insurance proceeds are excludible from the beneficiary's Federal gross income under Section 101(a) of the Internal Revenue Code (the "Code"). However, for employer-owned life insurance policies issued after August 17, 2006, under new Section 101(j) of the Code, an employer will be required to include in income the proceeds of insurance on the lives of employees and former employees to the extent the proceeds exceed the premiums and other costs paid by the employer, unless:

(1) certain notice and consent requirements are met; and

(2) one of the exceptions discussed below applies.

Under the Act, the notice and consent requirements are met if, before the policy is issued, the employee:

(1) is notified in writing that the employer-policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the policy is issued;

(2) provides written consent to being insured by the employer and acknowledges that the coverage may continue after the employee terminates employment; and

(3) is informed in writing that the employer will be a beneficiary of proceeds payable at the employee's death.

If the proper notice and consent requirements are met, death benefit proceeds are excludible from the employer's gross income if any of the following apply:

(1) Exceptions based on the insured's status with respect to the employer:

  (a) the insured was an employee of the employer-policyholder at any time within 12 months of death; or

  (b) the insured is at the time the policy is issued a director or a highly compensated employee or individual (subject to certain limits).

(2) Exceptions for amounts paid to the insured's heirs:

  (a) the proceeds are paid to a family member of the insured, a designated beneficiary of the insured under the policy (other than the employer), a trust for the benefit of a family member or designated beneficiary, or the estate of the insured; or

  (b) the proceeds are used to purchase an equity, capital or profits interest in the employer from any person described in (a) above.

In addition, the employer-policyholder must file an informational return which reports certain information regarding these policies and must keep whatever records are necessary to determine whether the requirements for exclusion are met.

The new law is directed primarily at employer-owned life insurance policies covering a broad-based employee population, which are essentially an investment vehicle for the employer. Provided the employee notice and consent requirements are met, proceeds of the typical key-person life insurance policy will remain non-taxable to the employer because the policy will qualify under one of the exceptions described above (i.e., the insured is a director or highly compensated employee when the policy is issued, the proceeds will be used to purchase the employee's stock or other capital interest in the employer, or the proceeds will be paid to the employee's family or estate). The most important aspect of the new law is the employee notice and consent requirements, which apply to all employer-owned life insurance policies issued after August 17, 2006.

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BS&K Tax Practice Group

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Income tax and estate planning, along with fiduciary estate administration, have been the staples of our practice for many years, attracting clients of all kinds with special business family planning needs. Our experience with succession planning for many closely held businesses and their owners involves the interplay of tax, estate planning and business issues. Employee Benefit counseling on Tax and Fiduciary issues represents a significant portion of our practice through involvement with both large and small client benefit plans. We provide business tax planning to optimize the benefits of the various forms of business entities and provide advice regarding the structure of taxable and tax deferred merger and acquisition transactions. Our counseling for tax-exempt organizations involves establishing and maintaining the exemption as well as unrelated business tax issues. Through our office in Albany, we also offer the means to address many New York State tax matters, particularly legislation and tax assessment controversies.

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