

Advanced Planning

Flash Point

Reminder: New Rules for Employer-Owned Life Insurance

Employer owned life insurance policies may run a broad spectrum, including but not limited to, policies issued for Buy Sell Agreements, Key Person Insurance, Non-qualified Deferred Compensation, Death Benefit Only (DBO) Plans, Rabbi Trusts, and certain Split Dollar plans. There are a number of gaps and potential traps in the new rules, which makes it easy for employers to run afoul of them. Keep in mind that the new rules apply to any employer who purchases a life insurance contract on any employee where the death benefit is payable, in whole or in part, to the employer. Producers who work with business owners, whether or not in the "COLI" or "EOLI" market, can provide essential services to those clients by understanding and explaining the new rules in this area.

What the Rules Say

The Pension Protection Act (PPA) of 2006 includes new IRC sub-sections 101(j) and 6039I, which set out the disclosure, consent, and reporting requirements for Employer Owned Life Insurance. The new requirements are effective for policies issued or materially changed after August 17, 2006. The thrust of §101(j) is to tax policy proceeds paid to an employer under a life insurance contract purchased by the employer on an employee's life unless certain conditions are met. Those conditions are relatively straightforward. Simply put, the disclosure and consent requirements are met if:

- (1) written disclosure was provided by the employer to the employee *prior to issuance of the policy*, stating (a) the employer's intent to purchase life insurance on the employee's life, (b) the beneficiary of the policy (in whole or in part) will be the employer or a "related person" as defined in the Code¹, and (c) disclosing the maximum amount for which the employee could be insured at the time the contract is issued; and
- (2) *prior to issuance of the policy*, the employee provides the employer with written consent (a) to being insured under the contract and (b) for the coverage to continue after the employee ceases employment with the employer.

Reporting Requirements

An employer who owns one or more life insurance policies on an employee's life is required, on an annual basis, to report specific data set out under IRC §6039I, including (but not limited to) the total number of employees of the employer at the end of the year, the number of employees insured by the employer at the end of the year, and that the employer has written consents from all insured employees to whom the consent requirement applies (or, if all such consents were not obtained, the number of insured employees for whom such consents were not obtained).

Onus on the Employer

The Code puts the onus on the employer to ensure the conditions are met if the employer expects to receive death benefits on a tax-free basis. Producers with employer clients will need to work closely with them and be conversant in the new requirements. Of particular importance to employers will be understanding that in addition to the notice and consent requirements, insured employees must fall within certain categories for the death benefit to be tax exempt to the employer. These include an insured who was an employee at any time during the 12-month period prior to death, or who at the time the contract was issued, was a director, a highly compensated employee², or a highly compensated individual³.

For more information, contact our Advanced Markets Group
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¹ See IRC §§ 268(b) or 707(b)(1)

² Within the meaning of §414(q) (without regard to (1)(B)(ii) thereof)

³ Within the meaning of §105(h)(5), (with '35 percent' substituted for '25 percent' in subparagraph (C))

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