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The Tax Trap of Employer Owned Life Insurance

The Pension Protection Act of 2006 contained a largely unnoticed provision that alters the way employer owned life insurance death benefits are taxed. Section 863 of the Act added IRC Sec. 101(j), applying to policies issued after August 17, 2006, (or issued pursuant to a 1035 exchange with material increases to the death benefit or material changes to the policy), in which a business is the owner of the policy, the business is directly or indirectly the beneficiary and an employee is the insured.

The general rule is that death benefits paid from a life insurance policy subject to IRC Sec. 101(j) are taxable when received. In order to avoid taxation of the death benefits, you must qualify for one of the following exceptions:

- the insured is a director or highly compensated employee.¹
- the employee/insured was employed by the business no later than 12 months prior to death.
- the death benefits are payable to the employee's heirs (family members, trust, estate).
- the death benefits are used to purchase an interest in the business.

In addition to qualifying for an exception, the employer must provide the insured employee with written notice stating:

- that the business intends to insure the life of the employee and that coverage may continue after the employee terminates employment;
- that the business will be the beneficiary of the life insurance policy; and,
- the maximum amount of life insurance coverage the business will obtain on the employee.

The insured employee needs to consent in writing to being insured and to having coverage continue after they terminate their employment **PRIOR TO ISSUANCE OF THE POLICY**.

In order to avoid taxation of the death benefits, the business also must report to the IRS (on IRS Form 8925):

- the number of employees of the applicable policyholder at the end of the year;
- the number of such employees insured under such contracts at the end of the year;
- the total amount of insurance in-force at the end of the year under such contracts;
- the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged; and,
- that the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).

Life insurance is often purchased by businesses to provide liquidity for redeeming stock under a buy-sell agreement, to protect the business from the loss of a key employee and to informally fund nonqualified deferred compensation plans. By not complying with the notice, consent and reporting requirements mentioned above, the death benefits from these policies will become taxed by the IRS which will lead to substantial cash flow issues for the business. Keep in mind that as of this date, there has been no relief guidance issued which would allow a policy that did not comply with the notice and consent requirement to avoid being taxed upon death. Any policies issued after August 17, 2006, should be reviewed for proper compliance.

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CBO Report on Options for Altering Federal Revenue and Spending

With changes in the White House administration, a transition of power in the Congress, a historical economic collapse, wars overseas, government bailouts and calls for the government to fix everything from health care to social security, it is inevitable that tax changes are on the way. The question is – where will the money come from and which tax laws will be affected? The Congressional Budget Office recently presented opinions to the House and Senate Committees on the Budget as to how to raise sufficient revenue to achieve all the federal government wants to accomplish. These are opinions from legislative proposals, the President’s budget, Congressional and CBO staff, other government agencies and private groups. They are, according to the report, intended to reflect a range of possibilities rather than to provide a ranking or a comprehensive list. The report contains a wide variety of opinions regarding how to alter federal spending and revenue - some of which could have a dramatic effect on planning for clients if made into law. The following are just a few of the opinions noted in the report (a full version of the report can be found at <http://www.cbo.gov/> under Recent Publications - Budget Options, Volume 2):

- Increase Individual Income Tax Rates
- Curtail the deduction for charitable giving
- Limit the Tax Benefit of Itemized Deductions to 15 Percent
- End the Preferential Treatment of Dividends Paid on Stock Held in Employee Stock Ownership Plans
- Disallow Tax-Free Conversions of Large C Corporations to S Corporations
- Modify the Estate and Gift Tax Provisions of EGTRRA
(Everything from a \$5,000,000 exemption to \$3,500,000 to \$1,000,000 is discussed)
- Include Investment Income from Life Insurance and Annuities in Taxable Income
- Permanently Extend the Individual Income Tax Provisions of EGTRRA

While it is impossible to predict exactly which opinions will be considered and which ones are simply academic, it is important to keep an eye on the proposals. Clearly all the options are on the table.

Cochran v KeyBank – Prudent Investor Rule and Trust Owned Life Insurance

A recent Indiana Court of Appeals case emphasizes the importance of trustees complying with the prudent investor rule when the trust owns life insurance. In the case of *In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009) the beneficiaries sued the trustee of a trust that held life insurance policies on the life of their father. Over a number of years the policies inside the trust had been exchanged twice for new policies. When the father passed away the death benefits were substantially less than the death benefit had been on the replaced policies (millions of dollars less). After reviewing the accounting of the trust, the beneficiaries attempted to sue the trustee for violation of the Indiana Prudent Investor Act which states in part that “a trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.” The plaintiff prevailed in large part due to their attempts to delegate the monitoring of the life insurance policies to outside advisors.

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