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New Law in Pension Protection Act May Tax Death Benefit of Employer-Owned Life Insurance

The new law, passed by Congress on August 3, affects policies issued after August 17, 2006. It does not matter what the purpose of the life insurance is. It can lead to income tax on the death benefit of life insurance used in arrangements like key person, split dollar, deferred compensation, as well as employer-owned policies bought to pay debts, etc.

New notice and consent requirements must be met before a policy is issued and the policy must fall into one of four safe harbors—generally meaning the insured must be a director or “highly compensated” employee or the proceeds are paid to the insured’s family. Otherwise, the death benefit is taxed as ordinary income except for premiums paid.

The law defines “employer-owned life insurance” broadly. It includes any policy if:

- The owner engages in a trade or business, and
- The owner (or a related party) is a beneficiary (direct or indirect), and
- The insured is an employee at the time of policy issue, and
- The insured is a US citizen or resident.

Written Notice and Consent

Before the policy issue date:

- The employer must give the employee (including owners, officers and highly compensated employees) written notice. This notice must include three statements:
 - The employer intends to apply for life insurance on the employee’s life.
 - The maximum face value the employee could be insured for at policy issue.
 - The employer will “be a beneficiary of any proceeds payable upon the death of the employee.”
- And, the employee must give written consent:
 - To being insured.

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- That the employer may continue the life insurance coverage even after the employee terminates employment.

4 Safe Harbors

To keep death benefits tax-free, the employer must provide written notice and receive written consent and at least one of the following safe harbors must also apply. Otherwise, the death benefit of an employer-owned life insurance policy, no matter why it was bought, is no longer fully income-tax free.

Safe Harbor 1: Current Employee

The insured was an employee any time in the 12-month period before death.

Safe Harbor 2: Key Person

At policy issue, the insured:

- Was a director of the employer
- Was a 5% or greater owner in the year before policy issue
- Received compensation of \$95,000 or more (adjusted for inflation)
- Was one of the five highest-paid officers
- Was among the 35% highest paid employees

Safe Harbor 3: Death Benefit Paid to the Insured's Heirs

- A member of the insured's family (spouse, parents and grandparents, children and grandchildren, brothers and sisters)
- An individual the insured named (other than the employer)
- A trust set up for anyone in those first two groups of people
- The insured's estate

Comment: Although this may avoid income tax on the death benefit, it does create a split dollar arrangement.

Safe Harbor 4: Buy-Sell Funds

Death benefits remain income tax free if used to buy the insured's interest in the employer (equity, capital or profits) from someone listed in Safe Harbor 3.

Record keeping and reporting

Every year, the employer must file a return with the IRS that shows its total number of employees, the number insured, and the total amount of life insurance in force. It must also report how many of those who are insured gave written consent. The employer must then keep whatever records are "necessary" for the IRS to see that the employer complied with the law.

Effective date

The new law applies to any policy issued after August 17, 2006, unless exchanged under Section 1035 for an older policy. Even if part of a 1035 exchange, the policy may still be treated as a new policy (and thus subject to the new rules) if there is a material increase in death benefit or if there are other material changes.

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