BEWARE OF THE TAX TRAPS OF EMPLOYER-OWNED LIFE INSURANCE CONTRACTS

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In closely held businesses, it is common practice to provide for the succession of the business upon the death of an owner. More often than not, such succession planning involves the use of life insurance on the life of an owner, whether to fund a redemption of the deceased-owner's interest in the company, to make up for lost revenues resulting from the owner's death, or to achieve other economic results. Where the company is the owner and beneficiary of the life insurance policy, the company and its principals (i.e. shareholders, members, partners) need to be mindful that certain formalities under the Internal Revenue Code (the "Code") must be followed to ensure that the death benefit proceeds are completely tax-free under the Code.

The Code generally excludes from gross income amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured. However, in the case of an employer-owned life insurance contract (i.e. a life insurance contract owned by a "person" engaged in a trade or business and under which such person is a beneficiary and that insures the life of an employee of such person on the date the contract is issued), unless certain requirements are satisfied, the amount excluded under the Code is limited to the aggregate amount of premiums and other related amounts paid by the employer. For instance, where an employer-owned life insurance contract pays $1 million to an employer on the death of the insured employee and the employer has paid $400,000 in premiums over the life of the contract, only $400,000 is excluded from gross income and the remaining $600,000 is subject to tax. An exception to the forgoing rule limiting the exclusion to the amount paid by the employer exists if certain notice and consent requirements are satisfied before the insurance contract is issued and (A) the proceeds are paid to certain heirs of the deceased employee or used to redeem the interest in the employer owned by the decedent; or (B) the insured was (i) an employee at any time during the 12 month period before the insured's death or, (ii) at the time the contract was issued, a director, highly compensated employee, or highly compensated individual.

Such notice and consent requirements are satisfied, if, before the issuance of the contract, the employee: (A) is notified in writing that the employer intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued; (B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment; and (C) is informed in writing that the employer will be a beneficiary of any proceeds payable upon the death of the employee. Keeping with the forgoing example, where the employee was a director at the time the policy was issued and all notice and consent requirements were satisfied prior to the contract's issuance, the full $1 million would be excluded from the employer's gross income under the Code and not be subject to tax.

The IRS has stated that actual knowledge, alone, is insufficient to satisfy such notice and consent requirements. As such, where a shareholder/employee of an S corporation causes the S corporation to purchase a life insurance policy on such shareholder/employee's life, absent the written notice and consent requirements described above being satisfied before the insurance contract is issued, the death benefit proceeds would only be excluded from gross income to the extent of amounts paid. According to the IRS, the fact such shareholder/employee had full knowledge and control of such insurance contract prior to issuance is

immaterial. Therefore, when structuring employer-owned life insurance contracts, careful attention must be paid to make sure the forgoing notice and consent requirements are satisfied in writing, prior to the issuance of the insurance contract. Such documentation may be accomplished in a variety of ways, such as in a limited liability company agreement, shareholders agreement, buy-sell agreement, formal notice and consent documents, etc.; provided, that, any such documentation is executed prior to the issuance of the employer-owned life insurance contract. In addition, the employer is generally required to file a Form 8925 with its federal income tax return for each year it has an employer-owned life insurance contract in effect and keep adequate records to support the information reported on Form 8925.

If you have any questions on this topic, please contact the author, Mitchell W. Goldberg, on the firm's Business, Finance & Tax Team.

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