

TAX UPDATE

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Congress Plants a Landmine—Company Owned Life Insurance
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Life Insurance and the Pension Protection Act of 2006

In the first week of August, the U.S. Congress was busy dealing with two major tax bills. The one that got the most press was one that didn't pass—a “Trifecta” bill that contained a compromise estate tax reform proposal that was, in the end, unable to garner enough votes to get through the United States Senate. However, Congress did manage to pass, with overwhelming support, the Pension Protection Act of 2006.

The 900 page bill contains a number of provisions and, like most bills Congress passes, it didn't limit itself to the topic the title would suggest exists in the bill. In addition to provisions impacting qualified retirement plans, the bill also contains a number of provisions impacting charities and charitable contributions and, buried under “Other Provisions” in the title of the bill labeled “Pension Related Revenue Provisions” is a bill that potentially creates a major landmine for what have been fairly routine uses of life insurance in a closely held business.

Congress's real concern appeared to be for cases that had made the press in recent years

where large publicly held companies had purchased life insurance on employee's lives as a tax planning strategy. One of the best known cases involved Wal-Mart and the developments in that case have been the subject of a number of newsletters from Leimberg Information Services. In that particular case, Wal-Mart's treatment was challenged by the IRS and they settled the case and then pursued relief from those that sold Wal-Mart the tax scheme. However, Congress apparently was concerned that other variants of the same idea might be sold, so they took it upon themselves to, with a single broad brush move, to eliminate these programs once and for all.

The bill generally removes the exclusion from income of life insurance death benefit proceeds that are paid on an “employer-owned life insurance contract” to the “applicable policyholder” of that policy. The problem is that the definitions are rather broad, and while traditional uses of such policies in small businesses have an exception available, that exception only comes into play if specific steps are taken before the policy is taken out.

The Law

Section 863 of the Pension Protection Act of 2006 adds a subsection j to Section 101 of the Internal Revenue Code (the section that generally excludes from income death benefits paid on a life insurance policy) along with new Section 6039I that deals with new required information reports.

New Section 101(j)(1) gives the general rule that will apply to “tainted” policies:

(1) GENERAL RULE- In the case of an employer-owned life insurance contract, the amount excluded from gross income of an applicable policyholder by reason of paragraph (1) of subsection (a) shall not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract.

Since, in most cases, the death benefits will be substantially more than the premiums paid for the policy, this could be a rather significant tax bill when it applies—and so, clearly, we'd like for it not to.

Like any provisions in the IRC, it's important to look at the definition of the terms contained in this general rule, since those definitions will tell us the real reach of the provisions. Key to understanding this rule will be understanding what is meant by *employer-owned life insurance contract* (the “bad” type of insurance) and what is an *applicable policyholder* (the party who is going to be nailed for the tax if the hammer of §101(j) comes down on the death benefit.

Employer-Owned Life Insurance Contract

The type of contract covered is defined in §101(j) itself at §101(j)(3)(A), which provides:

(A) IN GENERAL- For purposes of this subsection, the term “employer-owned life insurance contract” means a life insurance contract which--

(i) is owned by a person engaged in a trade or business and under which such person (or a related person described in subparagraph (B)(ii)) is directly or indirectly a beneficiary under the contract, and

(ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

For purposes of the preceding sentence, if coverage for each insured under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A, coverage for each such insured shall be treated as a separate contract.

So the real tests are this:

- An entity must be engaged in a trade or business;
- The entity must be directly or indirectly a beneficiary of a life insurance contract and
- The contract must cover someone who was an employee of that trade or business on the date the contract is issued.

Note that under this initial definition, any sort of “key man” life insurance would be covered, as would any life insurance held by an entity to fund a buy/sell agreement with an equity holder is also an employee of the entity—and, as we'll discover, due to “related party” rules referred in §101(j)(3)(A)(i), the reach may even hit some buy/sells that are handled via cross-purchase agreements.

Since the related party rules are actually contained in the provisions that define an “applicable policyholder” we'll first look at that provision.

Applicable Policyholder

This entity is the one who will end up with the bill, so it's important to know just who that is. As you might guess, since the bill separately defines “applicable policyholder” and “employer-owned” this entity could end up not necessarily being the common law employer of the individual in question. The definition is found at Section 101(j)(3)(B) which provides:

(B) APPLICABLE POLICYHOLDER- For purposes of this subsection--

(i) IN GENERAL- The term “applicable policyholder” means, with respect to any employer-owned life insurance contract, the person described in subparagraph (A)(i) which owns the contract.

(ii) RELATED PERSONS- The term “applicable policyholder” includes any person which--

(I) bears a relationship to the person described in clause (i) which is specified in section 267(b) or 707(b)(1), or

(II) is engaged in trades or businesses with such person which are under common control (within the meaning of subsection (a) or (b) of section 52).

Aside from the fact that following these definitions can appear to lead you in circles a few times, once you take it slowly you begin to appreciate that the “related party” provision is a key one.

There are two groups for control purposes. The group includes the general rules for “related parties” for denial of losses under Section 267 and for transactions between a partner and a partnership. The list of potentially related parties becomes relatively long at this point—Section 267(b) itself lists 13 different categories of potentially related parties. Of particular interest would be the treatment of an individual who owns more than 50% of a corporation, especially since the constructive ownership rules of Section 267(c) are to be used in interpreting Section 267(b). That would mean attribution for shares held by an individual's family as defined in §267(c)(4)--which means a brother, sister, spouse, ancestors and descendants.

As well, the definition includes those organizations that would need to be combined in applying the rules for the Work Opportunity Credit under Section 52, rules that are explained in detail in Regulation §1.52-1(b)--and generally uses rules similar to the corporate controlled group definition, but expands it to noncorporate entities.

The Section 267 rules are likely to cause the most headaches. Consider the case of a family corporation where the shareholders are two siblings and a parent. In this case, all of the individuals are potentially able to be an “applicable policyholder” and an insurance policy they hold could become an “employer-owned life insurance contract” in this case.

Now let's add an unrelated employee who owns a 40% interest in the entity, and a cross-purchase buy/sell arrangement with that minority shareholder where the family members plan to use life insurance on this individual's life to purchase back his interest. In that case, the policies held by the individuals are going to be “employer-owned life insurance” under the related party rules.

Even more interesting—and absurd. Let us assume that Joe owns 100% of XYZ Corporation and is the sole shareholder/employee. Joe's wife, Karen takes out a life insurance policy on Joe. By attribution Karen owns 100% of XYZ, which means the policy has become an “employer-owned insurance contract” under a literal application of the related party rules, turning Karen's tax free death benefit into a largely taxable benefit.

Did Congress Mean to Kill All Insured Buy/Sells?

Congress appears to have been aware that there are legitimate reasons why an employer would have insurance on an employee, and even that it is often used to acquire equity interests in a closely held entity at the death of a shareholder/employee. The good news is that Congress wrote an exception into the law to cover these cases. The bad news is that the application of these exceptions is not automatic—certain specific steps must be taken in order to bring your policy under the exception.

The exception provisions are found at §101(j)(2). There are two broad types of exceptions available—one based on the status of the individual and another based on the individuals who ultimately benefit from the proceeds of the policy.

The status exception is found at §101(j)(2)(A) and consists of the following:

(A) EXCEPTIONS BASED ON INSURED'S STATUS- Any amount received by reason of the death of an insured who, with respect to an applicable policyholder--

- (i) was an employee at any time during the 12-month period before the insured's death, or
- (ii) is, at the time the contract is issued--
 - (I) a director,
 - (II) a highly compensated employee within the meaning of section 414(q) (without regard to paragraph (1)(B)(ii) thereof), or
 - (III) a highly compensated individual within the meaning of section 105(h)(5), except that "35 percent" shall be substituted for "25 percent" in subparagraph (C) thereof.

It's important to note that the tests other than the one at Section 101(j)(2)(A)(i) are applied at the time the contract is issued. What that means is that for employees that don't fall into one of the "important person" classes found in Section 101(j)(2)(A)(ii) the death benefit must be triggered within 12 months of when the individual leaves employment. I would suspect this time period was placed in the law to reflect the fact that many policies have premiums that cover a one year period, so the issue would tend to be if the person was employed at the time the annual premium was due.

However, the other categories cover most cases that would exist in a buy/sell arrangement, presuming the individual had a substantial interest or their compensation was high enough to trip one of the "highly compensated" tests.

If the status isn't correct, there is another out available if the benefits will eventually end up going to an heir of the employee. That exception is found at §101(j)(2)(B) and reads:

(B) EXCEPTION FOR AMOUNTS PAID TO INSURED'S HEIRS- Any amount received by reason of the death of an insured to the extent--

(i) the amount is paid to a member of the family (within the meaning of section 267(c)(4)) of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured, or

(ii) the amount is used to purchase an equity (or capital or profits) interest in the applicable policyholder from any person described in clause (i).

Note that while this covers a lot of ground, there may be some holes here. The “designated beneficiary” definition seems to imply that the person has to be directly named as the beneficiary of the policy, which would seem to make it impossible to qualify under §101(j)(2)(B)(ii) based on a quick literal reading.

That could be a problem if the individual had a nonspouse life partner that was to be the person to receive the payout for purchase of the shares that were transferred outside of probate on the employee's death (perhaps it was placed into joint tenancy, as individuals are known to do to “simplify things”). The life partner wouldn't be a person with the specified relationship, and the payout would not go through the employee's estate or a trust established for that beneficiary.

The Notice and Consent Issue

Well, it seems like this is much ado about nothing, since the exceptions tend to cover most situations, at least ignoring the life partner issue noted above. However, Congress placed additional requirements on gaining access to the exceptions, requiring both a specific notice to the affected employee and specific written consent to be given before a policy is issued.

Those requirements are found at §101(j)(5), which reads:

(4) NOTICE AND CONSENT REQUIREMENTS- The notice and consent requirements of this paragraph are met if, before the issuance of the contract, the employee--

(A) is notified in writing that the applicable policyholder 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 an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

It is an interesting drafting job here, since the notice requirements are split in (A) and (C), while the consent provision sits in between the two in the statute.

Most likely an employer will want to include the text of the notice in the consent agreement the employee signs to help document that the notice was provided at the time the consent was obtained. As well, the consent will need to be dated prior to the date the policy is issued.

Note that the statute itself provides no corrective procedure if this consent is not obtained or a proper notice is not given. A real tax disaster would take place if the entities' advisors uncover this problem after the fact.

Relief?

Given the rather drastic results from the literal application of this provision, it may be that the IRS and/or Congress may act to establish some relief procedure. But since this provision will apply to all policies issued after the effective date of the Pension Protection Act of 2006, initially advisers should assume that no relief will be possible and assure if they are involved in a situation where insurance is being obtained that they consider whether it could be considered employer-owned under this provision and, if so, make sure the proper notice and consents are obtained.

But There's More

In addition to the provision noted above, Congress apparently also wants to know how many such policies are out there. New §6039I requires the following:

<p>SEC. 6039I. RETURNS AND RECORDS WITH RESPECT TO EMPLOYER-OWNED LIFE INSURANCE CONTRACTS.</p> <p>(a) In General- Every applicable policyholder owning 1 or more employer-owned life insurance contracts issued after the date of the enactment of this section shall file a return (at such time and in such manner as the Secretary shall by regulations prescribe) showing for each year such contracts are owned--</p> <ol style="list-style-type: none">(1) the number of employees of the applicable policyholder at the end of the year,(2) the number of such employees insured under such contracts at the end of the year,(3) the total amount of insurance in force at the end of the year under such contracts,(4) the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged, and(5) 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).

(b) Recordkeeping Requirement- Each applicable policyholder owning 1 or more employer-owned life insurance contracts during any year shall keep such records as may be necessary for purposes of determining whether the requirements of this section and section 101(j) are met.

(c) Definitions- Any term used in this section which is used in section 101(j) shall have the same meaning given such term by section 101(j).

It's important to note that an employer must notify the IRS that it has obtained the consents. Therefore, a failure to comply with the reporting requirements might be considered evidence that, just perhaps, the notice and consents were not truly made and obtained in a timely fashion. As well, this section makes clear it's the employer's responsibility to have documentation to show they have complied with provisions of Section 101(j), with the inference being that a failure to maintain such records would lead to a presumption that no exception will apply.