Employer-Owned Life Insurance Contracts: When and How To Use Them

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Renee C. Vidal and Steven S. Poulathas

In almost every shareholder, partnership or operating agreement, there are provisions for the interest of a deceased principal to be purchased by the entity, the other principals or some hybrid of both. Whether the arrangement is a cross-purchase, redemption or hybrid agreement, life insurance contracts are often used to fund the consideration due upon the death of a principal. To effectively use life insurance as a source of the consideration, the parties anticipate that the life insurance proceeds will be excluded from income tax. Under 101(j) of the Internal Revenue Code of 1986 (the "Code"), life insurance contracts owned by the entity conducting the trade or business and used to fund obligations under such agreements at the death of a principal, are now considered employer-owned life insurance ("EOLI") contracts and may be subject to income tax if the mandated notice and consent requirements are not met.

The Company Owned Life Insurance ("COLI") Best Practices Act, enacted as part of the Pension Protection Act on August 17, 2006, and the more recently issued IRS final regulations on Section 6039I of the Code, limit when EOLI contracts are excluded from income tax and provide that when they are excluded from income tax, notice, consent and information return compliance is mandated. Consequently, the preconception that gross income will never include proceeds from a life insurance contract owned by a business entity if the amounts paid are by reason of the death of the insured is no longer the case for any policy issued after August 17, 2006. After the enactment of COLI, the general rule with regard to an EOLI contract is that the amount excluded from gross income will not exceed the amount equal to the premiums and other amounts paid for the contract by the contract holder. Fortunately, as with any rule, there are exceptions that apply which exclude the proceeds of life insurance contracts in most circumstances where the entity owns a life insurance contract to fund the redemption of a principal's ownership interest, provided that specified requirements are met. Given the possibility of the significant tax consequences on large-sum life insurance contracts if included in gross income, insurance contracts funding redemption or hybrid agreements should be analyzed to determine if they constitute EOLI contracts. If an EOLI contract is being used, the parties to the buyout should be aware of which exceptions apply to exclude the EOLI contract from income tax and pay close attention to the notice, consent and information return requirements necessary for the exceptions to apply.

What is an EOLI Contract?

An EOLI contract is a life insurance contract owned by a person (including any partnership, company or corporation) engaged in a trade or business where that person or a related person is the beneficiary and which covers the life of an individual who is an employee of the applicable policy holder on the date the contract is issued. Code Section 101(j)(3)(A). This covers a broad spectrum of circumstances, including any situation where the redeeming entity owns life insurance contracts on the principals and where the principals also serve as officers, directors or are highly compensated (that is, the principals own five percent

of the company or make in excess of $80,000 per year and are among the top 20 percent of employees in wages). The definition also covers key man policies and split dollar policies.

What Can You Do To Avoid This Situation?

The most obvious answer may be to avoid having the entity own life insurance contracts on the principals. That could certainly be a simple solution but, unfortunately, may not be practical given a client's preference. Ensuring that an exception is met for the insurance contracts is another option. If the notice and consent requirements are met, the exceptions to the general rule of Code Section 101(j) (1) will exclude the life insurance proceeds from gross income. One exception applies to life insurance contract proceeds received by an applicable policyholder if the insured was employed by the policyholder within the 12-month period ending on the date of death (Code Section101(j)(2)(A)(i)), or the insured was a director or meets the definition of highly compensated under Code Sections 414(q) or 105(h)(5) with some modifications Code Section 101(j)(2)(A)(ii)) at the time the insurance contact was purchased. The other exception applies when the insurance proceeds are paid to an heir of the insured or used to purchase an equity (capital or profits) interest from the insured's heir. For these purposes, an heir includes a member of the insured's family, a beneficiary designated by the insured, a trust for the benefit of any of the foregoing, or the insured's estate. Code Section 101(j)(2)(B)(ii). If any of these exceptions are met, and the notice and consent requirements explained below are satisfied, then the proceeds will be excluded from gross income.

Notice and Consent Requirements of 101(j)

The notice and consent requirements are new and apply to any policy issued after the date of enactment of COLI. The notice and consent requirements provide that, before the contract is issued, the insured must be notified in writing that the applicable policyholder intends to insure the employee's life under a contract where the applicable policy holder will be the beneficiary. The insured must also consent in writing to being insured on such terms and that such coverage may continue after the insured's employment terminates. Additionally, the insured must be notified of the maximum face amount for which the employee could be insured. Code Section 101(j)(4). A practical way to deal with the notice and consent requirements is to place them directly in the agreement itself. Alternatively, separate notice and consent documents can be prepared at the time insurance contracts are being issued. In either case, the notice and the consent are required to be completed prior to the issuance of the insurance contract to meet the requirements to exclude the insurance proceeds from gross income.

Requirements to File Returns

The IRS recently issued final regulations under Code Section 6039I relating to the exceptions to Code Section 101(j)(1), providing that certain reporting and recordkeeping requirements must be maintained by the applicable policyholders. Every applicable policyholder who owns one or more EOLI contract issued after August 17, 2006, must file Form 8925, "Report of Employer-Owned Life Insurance Contracts" with the Internal Revenue Service for each year the contracts are owned. The filing must include the applicable policyholder's name, taxpayer identification number and the type of business the policyholder conducts. The return also requires a disclosure of the number of employees of the applicable policyholder at the end of the year and how many are insured under such contracts. Finally, the applicable policyholder must report the

total amount of insurance contracts in force and confirm whether or not it has a valid consent for each insured employee.

Planning Considerations

In planning the buyout provisions in shareholder, partnership or operating agreements, Code Section101(j) adds a new level of analysis to the equation. Complying with the notice and consent requirements is an easy first step. Even so, the impact of excess insurance proceeds should be addressed when one is relying on the exception for amounts paid to an insured's heirs under Code Section 101(j)(2)(B). In such a case, whether the entity or the family of the deceased principal receives the proceeds can affect whether the excess insurance proceeds will be included or excluded from gross income as the proceeds are excluded from gross income to the extent of the amount paid to the heirs. However, if the entity retains excess insurance, it may be included in gross income unless another exception applies to exclude the insurance proceeds.

The benefits and risks of alternative sources of funding a buy out should also be weighed. While life insurance can be a ready source of liquidity, the tax considerations discussed above along with the insurability of the principals and the need for a constant stream of up-front cash payments for premiums may not make economical sense for every client. When life insurance contracts are not attractive, other alternatives exist to fund a buyout. A cash buyout avoids the tax risks associated with Section 101(j), but requires that the business have a significant cash reserve on hand to satisfy the buyout, which when depleted may affect the operations or credit worthiness of the business. The entity could borrow funds to avoid using its own cash, but the risk is whether credit will be available or at a reasonable interest rate. Installment payments are a practical solution where the installments are tied to the valuation of the consideration, which can be partially based on the projected cash flow of the business. If the projected cash flow, however, does not follow suit, the payees will be exposed to the general credit risk of the entity or the personal guarantees of the other principals. Finally, the business may self-fund with an investment fund. This may allow the business to better manage its cash reserves and be prepared to be liquid. However, this also requires an up-front diversion of cash from the business operations and tax on the distributions and appreciation of the investments.

Overall, life insurance contracts continue to be an attractive solution for funding buyout provisions in shareholder, partnership and operating agreements.Careful planning is required where a life insurance contract can be deemed an EOLI contract to avoid the negative income tax consequences that would inadvertently interfere with an otherwise prudent plan.

ATTORNEYS MENTIONED

Steven Poulathas