Business Owned Life Insurance After the Pension Protection Act of 2006

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Breaking Developments:

- Not talking today about SOLI, but breaking news on **Stranger Owned Life Insurance, a.k.a Stranger Initiated Life Insurance (STOLI):**
  - *Calhoun* case out of NJ: Lincoln Insurance sued to rescind a $3M contract for fraud in application. Survived Dismissal. Trial Looms
  - Insurance businessman approached 75 yr. old Calhoun to participate in a premium financed insurance transaction where he'd apply for a policy then sell it 2 years later after contestability period for a profit at no cost to Calhoun (non-recourse financing)
  - Problem: Application asked Calhoun if "engaged in any discussions regarding sale or assignment of policy to a life settlement, viatical, or secondary market provider." Calhoun checked **"No."**
  - **Insurance Companies and Insurance Commissioners (e.x. recent Florida developments) are cracking down on the cottage industry of SOLI promoters and policies. Litigation has started.**

Background

- **COLI/EOLI** -- Many corporations and employers purchase life insurance policies insuring the lives of their employees.
  - **Fund buy-sell agreements**
  - **Protect against financial consequences of the death of a key employee**
- **General Rule** – the death benefit received by an employer under an EOLI policy is **excluded from the employer's gross income**

Background

- **Problem** – highly publicized cases of abuse of EOLI policies by employers led to Congressional action

- **Result** – Under Pension Protection Act of 2006, Congress added section 101(j) to the Internal Revenue Code which imposes new requirements on employers in an effort to combat abuses of EOLI policies

- **Section 101(j) is a trap for the unwary that may result in the taxation of EOLI death benefits in routine transactions!!!**

Background

- **Objectives Today:**
  - Brief Review of History of EOLI policies
  - Analyze and understand these changes found in section 101(j) passed in 2006, and the unforeseen consequences they can cause
  - Learn how to avoid problems that can drastically impact our clients and their EOLI policies

Brief History

- State laws generally required life insurance purchasers to have a "significant financial or emotional stake in the insured's survival."

- The 1980s and 1990s saw states expanding their **insurable interest** laws to permit employers to insure all employees, even **rank-and-file** employees
  - **a.k.a. "Janitor's Insurance" or**
  - **"Dead Peasants Insurance"**

Brief History

- **Initial Tax Benefit**:
  - Employers received **tax free insurance proceeds** on the death of an employee, AND
  - A **deduction** for the **interest** paid on the debt incurred to finance the insurance premiums

- Reforms in 1986, 1996 and 1997 curbed this deduction for interest paid on EOLI indebtedness, but Employers continued to purchase EOLI policies on broad bases of employees…

Brief History

- **Abuses:**
  - **Winn-Dixie Supermarkets:** purchased EOLI policies on 36,000 employees and borrowed against cash value to fund premiums. Income tax savings from deducting interest payments and fees exceeded benefits from EOLI program. IRS struck down as "Sham Transaction"
  - **Spencer Tillman Senate Testimony:** Tillman's brother Felipe worked for Camelot Music as a low-level employee. When Felipe passed away after only working for a couple years, Camelot made $340,000 under an EOLI policy, and Felipe's family, who knew nothing about the policy, received nothing

EOLI Changes

- **Old General Rule** – the death benefit received by an employer under an EOLI policy was **excluded from the employer's gross income…**

- **New General Rule – 101(j) –** Death benefits received under an EOLI policy in excess of the premiums paid for the policy (i.e. excess death benefits) **ARE included in the employer's gross income, UNLESS Employer meets certain requirements…**

EOLI Changes: New Requirements

- **All Death Benefits will be excluded from Employer's Gross Income IF:**
  - **Notice and Consent** Requirements are Followed, and
  - One of Two Classes of **Exceptions** Applies:
    - Insured's Status, or
    - Proceeds Paid to Insured's Heirs

New Requirements: Notice and Consent

- Employer Must Satisfy the Following 3 Requirements ***BEFORE the EOLI Policy is Issued***:
  - **Written Notice** to Employee of (1) Employer **Intent** to Insure their Life, and (2) the **Maximum Face Amount** for which the Employee could be insured at the time policy is issued;
  - **Written Consent** Provided by Employee to being insured and that such coverage may continue after termination of employment; and
  - **Written Notice** that Employer is the **Beneficiary** of the proceeds payable on the death of Employee

New Requirements: 2 Exceptions

- **I. Exception Based on Insured's Status:**
  - **Employee Must have Been:**
    - An Employee of Employer at any time within Twelve (12) Months prior to death of the insured Employee; or
    - At the time the contract was issued, a:
      - Director;
      - "Highly Compensated Employee" (5% owner or $80,000+); or
      - "Highly Compensated Individual" (one of the 5 highest paid officers, 10% shareholder or among highest paid 35% of all employees)
  - **Notice and Consent Still Required!!!**
  - If satisfied, all death benefits may be excluded…

New Requirements: 2 Exceptions

- **II. Exception Based on Proceeds Payable to Insured's Heirs:**
  - Amount is excluded to extent the amount is paid:
    - To a **member of the Family** of the insured;
    - Any individual who is a **Designated Beneficiary** of the insured under the contract – other than the employer of course;
    - A **Trust** established for the benefit of a member of insured's family; or
    - The **Estate** of the insured.
  - This exclusion will also apply if the amount is paid to any of these heirs **to purchase an interest in Employer** (e.g. amount's payable to an insured's heirs under an insurance funded buy-sell agreement)
  - **Notice and Consent Still Required!**

Effective Date

- These changes under 101(j) are effective on all EOLI policies issued after **August 17, 2006**
  - Importantly, any material increase in death benefit payable under an EOLI, or other material change to the policy, causes it to be treated as a new policy issued on the date of the change requiring Notice and Consent, etc.
    - "material change" is not clear or defined
  - Note – If one does a 1035 like-kind exchange, getting a new EOLI for old preexisting EOLI (pre-Aug. 17, 2006), these rules may not apply

Problem Resolution

- *Before the EOLI Policy is Issued…*
- What do we do if clients purchased EOLI policies after August 17, 2006, or had material changes to existing policies occur since then, but did not comply with Notice and Consent Requirements Prior to Purchase?
  - Terminate Existing Policies, Give Notice, Procure Consent, and Obtain New Policies;
  - Transfer Ownership so no longer constitutes EOLI
  - Other: ______________________________?

Application to Buy-Sells

- **Redemption Structured Agreements:**
  - Employer is Obligated to Redeem the equity interest of a deceased employee
  - Any EOLI policy purchased by Employer to Fund its purchase obligation will be governed by these EOLI rules
    - Should, in most cases, be eligible for exception for death benefits payable to insured's heirs in order to purchase equity interest, **provided Notice and Consent requirements are satisfied**

Application to Buy-Sells

- **Cross Purchase Agreements:**
  - Surviving Owners Required to Purchase Equity Interest of Deceased Owner
  - On its Face, 101(j) would not apply, because the policy would be owned by the equity owner, not the business, therefore not an EOLI, BUT…
  - Definition of "Applicable Policy Holder," to which EOLI rules apply, at 101(j)(3) includes certain ***"related persons"*** to the employer-policyholder: e.g.
    - Greater than 50% owner of corporation's stock;
    - Watch: Fiduciary and Trust Relationships
  - If policy is owned by an employee who owns more than 50%, these EOLI requirements would apply in a Cross-Purchase planning situation!!

Application to Buy-Sells

- **Watch "Maximum Face Amount" in the Notice Requirements**
  - Many Buy Sells base purchase price on FMV at time of death, so may want to increase death benefit over time
  - Thus, Employers will want to overstate or overestimate the "maximum face amount" in order to allow for future increases in the death benefit to be excluded from employer's income

Reporting and Recordkeeping

- Employer Must File **Form 8925** every year it owns an EOLI, reporting:
  - Number of Employees at year end;
  - Number of Insured Employees under an EOLI;
  - Total Insurance In-Force under EOLI policies at year end;
  - Name, Address, TIN of Employer and Type of Business; and
  - Valid **Consent** form for Each employee insured under an EOLI

- Employer Shall maintain records evidencing that Notice and Consent requirements complied with

Conclusion

- Tax Legislation intended to prevent abuses can adversely impact legitimate transactions

- Our challenge as advisors is to make our clients aware of these Notice and Consent requirements, and assist those clients who may have purchased EOLI policies after August 17, 2006 without complying and head off negative tax consequences NOW.

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The End.

Thank you for attending!