

The following article originally appeared in the August 5, 2008 issue of the DGC e-newsletter.

Is Your Corporate-owned Life Insurance Policy Subject to Tax?

By Joel Rothenberg

The purpose of a corporate-owned life insurance policy is to cover a shareholder or key employee. Typically, the corporation would use the proceeds as liquidity to redeem shares, fund a buy/sell agreement, etc.

In response to both real and perceived abuses of corporate owned life insurance, Congress passed strict notice and consent requirements under the Pension Protection Act of 2006. Prior to this act, the proceeds from a corporate owned life insurance policy were tax-exempt.

The Pension Protection Act of 2006 drastically changes this rule by taxing the insurance policy proceeds in excess of the premiums paid if the company does not obtain certain notice and consent documentation from the insured at the time of the issuance of the insurance policy. This rule applies to all insurance contracts that were issued (or materially modified) after August 17, 2006. In addition, the corporation must file a form with its corporate income tax return for each year such contracts were owned.

However, if the "employer-owned life insurance contract" meets the notice and consent requirements, the proceeds will not be subject to tax.

Only certain individuals may be insured under an "employer-owned life insurance contract". The "insured" must be:

- an employee at any time during the 12 month-period before the insured's death;
- a director at the time the policy was issued; or
- a "highly compensated employee and/or individual" (as specifically defined in the Internal Revenue Code) at the time the policy was issued.

In addition, the "employer-owned life insurance contract" may allow proceeds to be paid to certain parties other than the insured, including the insured's estate, etc. Finally, the contract may allow the corporation to use the proceeds to purchase an equity interest.

Our advice: Check with your insurance representative to make sure that the notice and consents were executed at the time the policy was put into effect and that the individual insured under the insurance contract meets the requirements of this legislation. Please ask your tax advisor for assistance in determining whether your plan is in compliance.