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Employer Owned Life Insurance Policies

Special tax rules apply to life insurance policies that are actually owned by a business. The two most common scenarios in which an employer would own a life insurance policy on an employee are as a funding instrument for an entity purchase buy-sell agreement or to protect the business through key-employee life insurance. In both cases the tax ramifications would be the same.

Common Scenarios Where Employer Owned Life Insurance is Used

Funding Entity
Purchase Buy-Sell
Agreements



Key-Employee
Protection Needs

Employer owned life insurance policies must adhere to additional rules to preserve tax-free treatment of the death benefit. These rules emerged as part of the *Pension Protection Act (PPA)* and are codified in IRC §101(j). The rules allow for the death benefit to be tax-free when two conditions are met:

1. The insured meets *at least one* of the following requirements:
 - a. They were an employee of the business at some point in the 12-months immediately prior to death.
 - b. They were a director of the corporation when the policy was issued.
 - c. They were a *highly compensated employee* at the time the policy was issued.
 - d. They were among the highest paid 35% of employees at the time the policy was issued.
 - e. The death benefit is used to pay benefits to the employee's heirs or estate.
 - f. The policy is used to purchase the ownership interest from the deceased's estate as part of an entity purchase buy-sell agreement.
2. Qualifying notification was made and consent obtained *prior to the policy being issued*. That means:
 - a. The employee was notified in writing of the business's intent to purchase a policy on their life;
 - b. The notice details the amount of coverage the business might be seeking to acquire;
 - c. The notice explains the business will be the beneficiary of the proceeds;
 - d. The employee provides written consent to being insured by the business; and
 - e. The employee provides written consent that the coverage can be kept by the business even after he or she no longer works for them.

It is **essential** that the IRC §101(j) compliant *Notice* be given and *Consent* obtained prior to the business-owned life insurance policy being issued. Failure to do so may subject the death benefit to income taxation.

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Additionally, the PPA requires that businesses owning life insurance policies file an annual report with the IRS using Form 8925. This form discloses to the government details about all business-owned life insurance policies.

Complying with IRS Rules for Employer Owned Life Insurance Policies

STEP 1



101(j) Compliant
Notice and Consent



STEP 2



Obtain Life
Insurance Policy



STEP 3



Annual
Documentation
(Form 8925)

Deductibility of Life Insurance Premiums for Businesses

Unfortunately, IRC §264 dictates that businesses are typically **not** allowed to deduct the costs of premiums paid for policies they own. This is true for nearly all situations in which a business might own a policy, including policies owned for the purpose of key-employee protection or to fund entity purchase buy-sell arrangements.

The lone exception to this rule is for coverage paid for by the employer as part of an employer-provided **group term insurance** plan under IRC §79. In those situations, the premium cost for the first \$50,000 in coverage is deductible by the business as an expense and is *not* taxable to the employee as income. If the employer provides coverage above the \$50,000 limit, the excess coverage will be taxed to the employee as “imputed income” in the amount equal to the “economic value” of the coverage. That economic value is determined by the IRS’s *Uniform Premium Table* on a *per thousand dollar* basis of coverage.

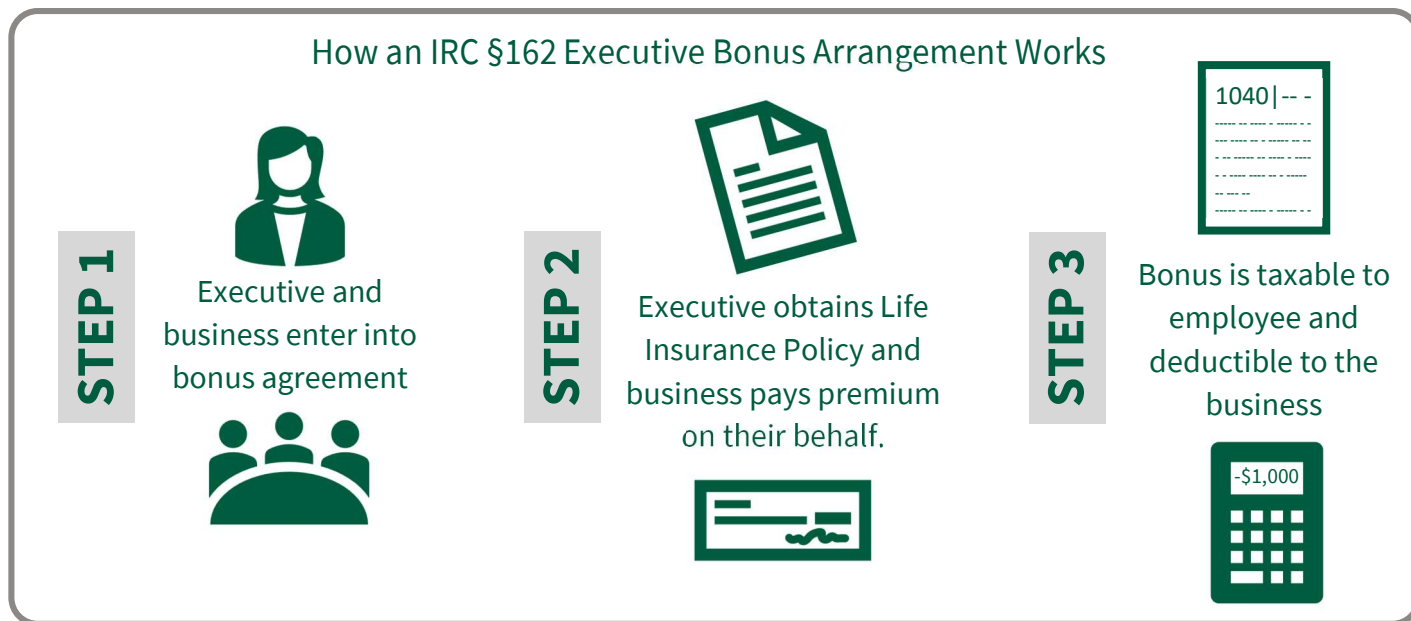
Employer Supported, but not Owned, Life Insurance Policies

Life insurance is commonly used by businesses as a supplemental benefit under an employee’s overall compensation package. In these instances, the policy is not generally owned by the business but is owned by the employee. The business simply helps provide the funding for the purchase of the desired life insurance. This is commonly known as an **Executive Bonus Arrangement**, or a Section 162 Bonus Arrangement.

In an Executive Bonus Arrangement, the employee owns the policy and determines who the beneficiary might be, in addition to being the insured under the policy. The only role played by the employer is to help provide the funds to

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purchase the policy through a taxable bonus arrangement. Because the employer does not own the policy in executive bonus arrangements, the strict IRS rules related to IRC §101(j) do not apply.



IRC §162 Executive Bonus arrangements *do* allow for a tax deduction, but only because 1) the business is not the owner or beneficiary of the policy and 2) the premium payment is attributed to the employee as a taxable bonus related to their overall compensation package. In essence, it is not the premium that is deductible, but the bonus paid as reasonable compensation (which the employee uses to pay the premium) which is deductible. That bonus is then taxable to the employee for whom the policy premium is paid.

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