



## Seven Tax Traps for the Unwary

by

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The Pension Protection Act of 2006 introduced the notice and consent requirements of IRC Sec. 101(j)(4) and the reporting requirements IRC Section 6039I -- both related to employer-owned life insurance. A summary of the requirements is listed below and details of the Seven Tax Traps follow.

With respect to the notice and consent requirements of IRC Sec. 101(j)(4), they are met if, before the life insurance policy is issued, the employee:

- is notified in writing that the employer intends to insure the employee's life and the maximum face amount of the coverage at the time the coverage is issued;
- gives written consent to being insured under the contract and continuation of such coverage after the insured employee terminates employment; and
- is informed in writing that the employer will be a beneficiary of policy death proceeds.

Note: The insurance application is not sufficient to meet the notice and consent requirements.

With respect to the reporting requirements of IRC Section 6039I, an employer that, after August 17, 2006, has one or more employer-owned life insurance contracts must file a return using IRS Form 8925 that shows for each year the policy is owned:

- the number of employees employed at the end of the year;
- the number of employees insured under employer-owned life insurance contracts at year end;
- the total amount of insurance in force under such contracts at the end of the year;
- the name, address, and taxpayer identification number of the employer and the type of business in which the employer is engaged; and
- that the employer has a valid consent for each insured employee (and, if applicable, the number of insured employees for who such consent was not obtained).

**Filing Requirements** -- Any employer (or other applicable policyholder) that owns one or more employer-owned life insurance contracts during the year must file IRS Form 8925 with its income tax return (starting with the tax return for 2007, if applicable).

**Record Keeping Requirements** -- Any employer (or other applicable policyholder) that owns one or more employer-owned life insurance contracts during the year must keep whatever records are necessary to determine whether the requirements of the IRC Sections 6039I and 101(j) are met. *It is strongly recommended that copies of the forms executed regarding IRC Sections 6039I and 101(j) be filed with the respective life insurance policy(ies).*

### **Tax Trap #1**

Any business that was issued an employer-owned policy after August 17, 2006, must have had the notice and consent document executed prior to the issue of the policy. If not, any death benefit of the policy paid to the business in excess of the cumulative premiums will be ordinary income to the business.

There is no way to correct this consequence unless the insurance company is willing to reissue the policy with a current date, and the appropriate notice and consent document is executed prior to the reissue. If the insurance company is unwilling or unable to reissue the policy, replacement is likely the best alternative to avoid Tax Trap #1.

### **Tax Trap #2**

The IRS has developed Form 8925 for reporting relative to IRC Section 6039I. Normally, you would expect the accountant of a business to inquire as to whether the business owns life insurance contracts that were issued after August 17, 2006. This is not happening. Almost all CPA firms provide each client with a checklist that should include this item for 2007 returns.

I have inquired of a dozen CPA firms, and none of them have done so in the 2007 checklists supplied to clients. This means that the likelihood of Form 8925 being filed when required in conjunctions with 2007 returns is not overwhelming.

One of the most common responses I received from accountants was, "I didn't even know that Form existed." You can help, and CPAs and attorneys in your sphere of influence need to know about this issue.

Note: Some insurance companies have been providing guidance and copies of forms and specimen documents; *others have not*. Some CPAs and attorneys are aware of these issues; *others are not*.

### **Tax Trap #3**

It is not uncommon that ownership of personal policy is transferred to a business IRC Secs. 101(j)(4) and 6039I are totally silent on a policy transfer if it were to occur after August 17, 2006 for a policy issued prior to that date -- except for the following language that appears in IRS Form 8925:

“...any...material change to the contract will cause it to be treated as a new contract and the policyholder is required to file Form 8925.”

Is a transfer of ownership a “material change”? I don't know, and neither does anyone else because nowhere does the IRS identify what constitutes a material change as regards IRC Secs. 101(j)(4) and 6039I.

What should one do in this instance? Technically, if a policy was “issued” prior to August 17, 2006 and transferred after that date, should this policy owner wait until the insured dies and then allow the IRS to determine whether the change of ownership was a material change?

One business that experienced this situation developed the following language relative to notice and consent and included it in a document signed by both parties:

Regarding the intended transfer of the ownership of the above referenced policy to [Name of Company] (hereinafter "Company") insuring the life of [Name of Insured] (hereinafter "Insured"): Although said policy was issued to Insured prior to August 17, 2006, the transfer of ownership and beneficiary of said policy to Company is scheduled to occur on or about April 15, 2007, which occurs after August 17, 2006. Said change of ownership and beneficiary may be considered a material change of the policy by the Internal Revenue Service. In consideration of this, the following Notice and Consent is hereby executed:

#### **Company's Notification to and Information for the Insured**

In accordance with the requirements of Internal Revenue Code Section 101(j)(4), Company hereby notifies Insured that Company is willing to accept a transfer of ownership and beneficiary to Company of the above referenced policy of insurance owned by Insured and currently in force on Insured's life. After the transfer, Company intends to pay the premiums on said policy and keep said policy in force during the period of Insured's employment with Company and indefinitely thereafter. The maximum face amount for which Insured will be insured in favor of Company when the contract is transferred is \$[1,000,000].

#### **Insured's Consent to be Insured and Acknowledgement of Company's Notification**

Insured hereby acknowledges that [he/she] has read, understands, and consents to Company's expressed intentions and information contained in the paragraph above entitled "Company's Notification to and Information for the Insured". Specifically, but without limitation, Insured acknowledges and consents to the following:

- Company currently has an insurable interest in Insured's life;
- Company, in its discretion, may acquire, purchase, own, and be the beneficiary of all or part of one or more policies of insurance on Insured's life;
- Company, in its discretion, may keep such policy or policies in force during the period of Insured's employment with Company and indefinitely thereafter;
- The maximum face amount for which Insured will be insured when the insurance contract is transferred is the amount set forth in above.

Belt and suspenders? Maybe, but a pretty good approach to a potential problem.

#### **Tax Trap #4**

A Section 1035 exchange on its own does not cause a policy to come under the new requirements unless, as stated in Form 8925, an increase in death benefit has occurred *or other material change*. Again, there is no IRS help to define a material change -- so be careful with 1035s.

#### **Tax Trap #5**

Split Dollar Arrangements: If proper notice and consent is given, death benefits payable to a business and family members of the insured under a split dollar arrangement are exempt from the income inclusion requirements of Section 101(j)(1). However, if the notice and consent requirements are not met, any death benefit payable to the business (or a party related to the business, such as a greater than 50% shareholder of the business) in excess of its premiums paid, would result in making that excess amount taxable. This means that most employer-employee economic benefit split dollar arrangement (commonly referred to as endorsement split dollar) would need to meet the notice and consent requirements. On the other hand, most loan regime split dollar arrangements would not.

If the employer's interest in the death benefit never exceeds its premiums paid, no part of the death benefit the business receives should be taxable; however, some authorities include any kind of employer-sponsored split dollar life insurance and life insurance owned by co-shareholders and partners for buy-sell purposes within the scope of IRC Section 101(j). In any event, the reporting requirements of IRC Section 6039I must be met.

#### **Tax Trap #6**

Rabbi Trust: Because a rabbi trust is a grantor trust established by an employer (Company) to meet its obligations under a nonqualified deferred compensation plan, the rabbi trust would be treated the same as the employer (Company) for purposes of Sections 101(j) and 6039I. Thus, all the requirements discussed above relating to the Company would apply to insurance death benefits owned and received by a rabbi trust.

#### **Tax Trap #7**

Secular Trust: Because a secular trust is funded by an employee with after-tax dollars, Section 101(j) would generally not apply. However, where the grantor of the secular trust is a party related to the Company, such as a controlling shareholder, the notice and consent and reporting requirements of Section 101(j) and 6039I may apply.

#### **Resources**

Much of the material in this article was excerpted from InsMark's Documents On A Disk<sup>®</sup> ("DOD") System. For information about DOD, please contact an InsMark Account Executive at 1-888-InsMark (467-6275). Institutional inquiries should be made to David Grant, Sr. V.P. - Sales at 1-925-543-0513 or [dag@insmark.com](mailto:dag@insmark.com). InsMark is located at 2400 Camino Ramon, Suite 150, San Ramon, CA 94583 (website: [www.insmark.com](http://www.insmark.com)).

#### **Important Note**

Examples in this article are for discussion purposes only and are not all-inclusive of the issues. Legal and tax information is for general use only and may not be applicable to specific circumstances. Clients should consult their own legal, tax and accounting advisors to assist in evaluating and complying with IRC Sec. 101(j)(4) and IRC Section 6039I.

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