



Six Tax Traps for the Unwary Employer

Company-Owned Life Insurance,

Company-Owned Endorsement Split Dollar,

Company-Sponsored Loan Regime Split Dollar

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 -- applying to company-owned life insurance and endorsement split dollar. A summary of the requirements is listed below and details of the Six 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 1) insure the employee's life or 2) enter into an endorsement split dollar arrangement with the employee or 3) loan premiums to the employee for the purpose of purchasing a life insurance policy, and lists 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 all, or a portion 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 has one or more employer-owned life insurance contracts or split dollar arrangements involving policies issued after August 17, 2006, must file a return using IRS Form 8925 that shows for each year the policy is owned or the split dollar arrangement is in effect:

- the number of employees employed at the end of the year;
- the number of employees insured under employer-owned life insurance contracts or split dollar arrangements at year end;
- the total amount of insurance in force under such contracts or arrangements 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 -- Starting with tax returns for 2007, any employer that owns one or more employer-owned life insurance contracts or is involved in one or more split dollar arrangements must file IRS Form 8925 with its income tax return.

Record Keeping Requirements -- Any employer (or other applicable policyholder) that owns one or more employer-owned life insurance contracts or is involved in one or more split dollar arrangements during the year must keep whatever records are necessary to determine whether the requirements of the IRC Sections 6039I and 101(j) are met.

Tax Trap #1

The IRS developed Form 8925 for reporting relative to IRC Section 6039I. 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.

Normally, you would expect the accountant of a business to inquire each year whether the business owns life insurance contracts issued after August 17, 2006, or is involved in split dollar arrangements with insurance contracts issued after August 17, 2006. This inquiry is not happening consistently. Almost all CPA firms provide each client with a checklist that should include these items, but many don't. This means that the likelihood of timely execution of Notice and Consent and the filing of Form 8925 when required is not overwhelming.

Note: Some insurance companies are providing guidance and copies of forms and specimen documents; *others are not*.

There is no way to correct the absence of the appropriate Notice and Consent 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

In answering Question 3 on Form 8925, it is not clear whether the death benefit to be reported in a split dollar arrangement would be the total death benefit or the employer's portion of the death benefit. The safer and more conservative method is to report the policy's entire death benefit.

Tax Trap #3

Portion of Death Payable to an Employer Under a Split Dollar Arrangement: If the portion of the death benefit payable to an employer under a split dollar arrangement exceeds the employer's premium payments, Sec. 101(j)(4) and the reporting requirements IRC Section 6039 apply. This is a common occurrence in later durations of an endorsement split dollar arrangement if the policy cash value exceeds the employer's premium payments. When this occurs, if the split dollar agreement is written to increase the employer's death benefit correspondingly, Sec. 101(j)(4) and the reporting requirements IRC Section 6039 should apply. A client's legal and tax advisers should carefully review this aspect of the split dollar documentation as well as the projected death benefit payable to the employer in the split dollar illustration in all durations.

Loan regime split dollar typically does not produce a death benefit payable to an employer that exceeds the employer's premium payments. In this case, Sec. 101(j)(4) and the reporting requirements of IRC Section 6039 should not apply.

Tax Trap #4

Section 1035 Exchanges: A Section 1035 exchange of an in-force employer-owned policy or one subject to a split dollar arrangement does not necessarily cause the policy to come under the new requirements unless, as stated in Form 8925, an increase in death benefit has occurred *or other material change*.

The IRS has identified certain changes that are not considered material:

- (i) increases in death benefit that occur as a result of either the Section 7702 (definition of a life insurance contract) or the terms of the existing contract (provided the insurer's consent to the increase is not required);
- (ii) administrative changes;
- (iii) changes from general account to separate account (and vice versa);
- (iv) changes as a result of the exercise of an option or right granted under the contract as originally issued.

Examples of such changes are:

- (a) a death benefit increase necessary to keep the contract in compliance with Section 7702;
- (b) a death benefit increase resulting from the application of policy dividends to purchase paid-up additions;
- (c) a death benefit increase resulting from market performance or contract design involving a variable contract.

It is not clear if potential increases in death benefits that may occur must be taken into account in complying with the notice and consent requirements and, if so, how they must be communicated. Presumably, these features for potential death benefit increases would have to be disclosed, but it is not clear whether they should be quantified in some manner.

Tax Trap #5

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

Tax Trap #6

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, and all the requirements discussed above would apply to insurance death benefits owned and received by a secular trust.

Document Resource

Among its 1,000 plus documents, Version 19.0 of InsMark's Documents On A Disk[®] ("DOD") contains specimen document sets for over 50 employer-owned and split dollar life insurance transactions involving over 400 individual specimen documents. Each set contains a narrative explanation of the particular variation, a technical preface plus specimen resolutions, agreements, ERISA documents, Notice and Consent Forms as well as the Annual Reporting Form.

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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Revised 12-15-09
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