

## ATTENTION EMPLOYERS

### Employer-Owned Life Insurance Rules Have Changed

Are you thinking about purchasing key person life insurance on yourself or one of your employees to help indemnify the business against financial loss in the event of one of your deaths? Perhaps you are considering the purchase of life insurance to assist in financing the cost of employee benefit plans or to help fund the purchase of a business interest under the terms of a buy-sell agreement. If so, you will want to take time to read this flyer because the rules have changed.

#### How Have the Rules Changed for Employer-Owned Life Insurance?

For *employer-owned contracts* issued after August 17, 2006, the Pension Protection Act generally provides that death proceeds will be subject to income tax; however, where specific employee notice and consent requirements are met, and certain exceptions apply, death proceeds can be received income-tax free.

#### What is an Employer-Owned Contract?

The starting point to understanding the impact of the legislation is to recognize what it calls an *employer-owned contract*. An employer-owned contract is defined as a life insurance contract

- That is owned by a person engaged in a trade or business (*applicable policyholder*, as defined by the law)
- Under which such person, or related person (as defined by the law), is directly or indirectly a beneficiary, and
- That covers an insured that is an employee of the trade or business of the applicable policyholder on the date the contract is issued.

Clearly this definition includes policies where a business is the owner and beneficiary. What's not so obvious is that, under the *applicable policyholder* and *related party* definitions, the legislation expands its reach to a broad group of individuals and entities such as family members, trusts, and estates.

#### Notice and Consent Required Prior to Issue

Congress apparently was aware that this broad definition could negatively impact many valid business uses, so it included a number of exceptions in the legislation. However, the exceptions only apply where the employee receives **notice of, and consents to, the following in writing prior to policy issue:**

- The applicable policyholder intends to insure the employee's life and specifies the maximum face amount for which the employee will be insured at time of issue;
- The employee consents to being insured and agrees that such coverage may continue after he/she terminates employment; and
- The applicable policyholder will be the beneficiary of the death proceeds paid.

Meeting the notice and consent requirements is a critical first step to avoiding taxation of death benefits applicable to employer-owned contracts. However, notice and consent is not the only requirement imposed by the legislation. Employer-owned contracts must also fall within one of the following exceptions.

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**Exception: Based on an Insured's Status**

This exception provides that the income inclusion rule will not apply to employer-owned contracts provided the insured was either:

- An employee at any time during the 12-month period prior to death, or
- A director, a *highly compensated employee*<sup>1</sup>, or a *highly compensated individual*<sup>2</sup> at the time the contract was issued.

**Exception: Based on Who Receives the Death Benefit Proceeds**

This exception states that the income inclusion rule will not apply to an amount received at the death of an insured to the extent the amount is paid:

- To a family member of the insured;
- To an individual, other than an applicable policyholder, who is the designated beneficiary of the insured;
- To a trust established for the benefit of a family member or designated beneficiary;
- To the estate of the insured; or
- Where the policy proceeds are used to purchase an interest in the applicable policyholder from such family member, beneficiary, trust, or estate.

**Reporting & Record Keeping Requirements**

The legislation also mandates annual reporting of employer-owned contracts for each year the contracts are owned. This reporting is provided on IRS Form 8925 and attached to the policyholder's tax return. Form 8925 requires the following:

- The number of employees at the end of the year;

- The number of employees insured under such contracts;
- The total amount of insurance in force under such contracts;
- The name, address, taxpayer identification number of the applicable policyholder as well as the type of business; and
- An attestation that valid consent has been obtained from each insured, or where all consents have not been obtained, the number of insureds for whom such consent was not obtained.

In light of these reporting rules, it's extremely important that you maintain documentation that proves that you have met the notice and consent requirements in a timely manner.

**Remember**

Life insurance policies can still provide income-tax-free death benefits to help you meet your business goals, but the key to a successful plan is following the rules.

In light of the broad application of this legislation it is important that you understand these rules prior to entering into a transaction involving an employer-owned life insurance contract.

<sup>1</sup> *Highly compensated employees* include employees who were 5% owners of the business at any time during the preceding year or who received compensation in excess of a specific amount during the preceding year (\$100,000 if the preceding year is 2006, \$105,000 if the preceding year is 2007, indexed for inflation in future years).

<sup>2</sup> *Highly compensated individuals* include the five highest-paid officers or individuals who are among the highest-paid 35% of all employees.

A sample generic Acknowledgment and Consent to Employer-Owned Life Insurance form appears below. Please be aware that this form has not been adapted to the specific circumstances or objectives of an individual employer. Neither The Prudential Insurance Company of America nor its representatives provide tax or legal advice. We strongly urge you to consult with your attorney to understand the application of these rules to your situation prior to completing an employer-owned life insurance transaction.

## Sample Acknowledgment and Consent to Employer-Owned Life Insurance

Proposed Insured Name: \_\_\_\_\_

Employer/Applicable Policyholder Name: \_\_\_\_\_

Employer/Applicable Policyholder Address: \_\_\_\_\_

### Employee Acknowledgment and Consent

The employer/applicable policyholder has given me notice that it intends to purchase a life insurance policy or policies on my life. I understand and consent to the following:

- I will be the insured under the policy(ies).
- The employer/applicable policyholder will own the policy.
- The employer/applicable policyholder may, directly or indirectly, be a beneficiary of the policy(ies) and may receive proceeds payable on my death.
- The employer/applicable policyholder, or its successors, may continue to be the owner and/or may be a beneficiary of the policy even after my employment terminates.
- \$\_\_\_\_\_ is the maximum face amount for which I may be insured by the employer/applicable policyholder at time of issue.

**X**

\_\_\_\_\_  
Signature of the Proposed Insured

\_\_\_\_\_  
Date

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