Have you reviewed your employer-owned life insurance policies to make sure the death benefit will be received tax free?

Normally, life insurance proceeds received by the beneficiary are not subject to income tax. However, as part of the Pension Act of 2006, proceeds from employer-owned life insurance (EOLI) contracts issued after Aug. 17, 2006, are taxable to the beneficiary as ordinary income, to the extent that such proceeds exceed the sum of the premiums and other amounts paid by the policyholder (cost basis).

All businesses are subject to this legislation if the employer is the owner and the direct or indirect beneficiary of the contract and the employee, as defined in Internal Revenue Code Section 101(j), is the insured.

Now is the time to review all employer-owned life insurance contracts, including key-person policies, buy-sell agreements and nonqualified deferred compensation plans to verify the income tax status of the policy proceeds.

If the policy was issued before Aug. 18, 2006, and not materially modified after that date, there are no special rules for the exclusion of proceeds from EOLI contracts, and the proceeds are therefore not subject to income tax.

For policies issued after the effective date of Aug. 17, 2006, don’t panic yet.

An exception was created in the Pension Act of 2006, and the IRS issued new guidance in IRS Notice 2009-48, effective June 15, 2009. The exception states that the amount excluded from the policyholder’s gross income shall not exceed the sum of premiums and other amounts paid for contract, satisfaction of notice and consent requirements.

The new guidance says that, before an EOLI policy is issued on the life of an owner-employee, employee, director or independent contractor:

- The insured individual must be given written notice that the employer intends to insure the employee’s life, and the employer or other applicable policyholder will be the beneficiary of the policy; and
- The insured individual must be given notice of the maximum face value of the insurance policy as of the date the policy is issued; and
- The insured individual must provide written consent to being insured under the policy and acknowledge that the coverage may continue should employment be terminated.

The contract for the insurance policy must be issued within one year after the date of the written consent or, if earlier, before termination of the individual’s employment.

If the policy’s insurance amount increases above the amount in the original notice, then the employer should obtain new written consent from the insured individual.

Notice and consent can be provided electronically, subject to the rules applicable to electronic notifications and signatures. The IRS will not challenge a taxpayer who made a good-faith effort, e.g., there must be a system in place for providing notice and securing consent, to comply with the notice and consent requirements before the effective date of the new rules, which is June 15, 2009.

The new notice and consent obligations also require that the “applicable policyholder” (employer) provide notice annually to the IRS via Form 8925 to include:

- The number of employees employed by the policyholder at the end of the year
- The number of such employees insured under the contract

A tax information bulletin to our clients and business associates from:

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Important information for those with tax liens from the IRS

Do you have outstanding tax liens? If so, you can still salvage your credit standing, but you need to know how.

In today’s economy, keeping a good credit score is more important than ever. A bad credit score can mean no car loan or mortgage or higher interest rates. Tax liens can ruin your score. Even if you eventually pay the tax, the lien filing remains as a black mark on your credit score. There is another way, however.

The IRS has a procedure to “withdraw” filed tax liens. Unlike a lien release, a withdrawn lien retroactively removes the lien as if it was never filed. Unfortunately, most people and many tax preparers do not know about the procedure, and handling the paperwork without help can be difficult.

To have a lien withdrawn, one must convince the IRS that there is a valid reason to withdraw, and one must seek withdrawal timely. Even if you can’t pay tax immediately, you may still qualify for a withdrawal. But you must act quickly. The IRS will, of course, withdraw a lien that was issued in error because the tax was already paid. Unfortunately, the IRS issues erroneous liens more often than people realize.

Assuming there was a valid unpaid tax debt, it is still possible to have the lien removed if the IRS has failed to follow all of its administrative procedures. Here having the assistance of a knowledgeable CPA is a must.

The IRS may agree to remove the lien if you are able to work out an installment agreement or if you can convince them that withdrawing the lien will facilitate collection. Again, having the help of a good CPA is important.

Once the lien is withdrawn, do not expect that the credit reporting agencies will automatically adjust your records. Often you must contact the three credit reporting agencies and continue to follow up until your records are corrected. Your CPA can help if the credit agencies fail to correct your records.

While it is always best to avoid having the lien filed in the first place, the loss of a job or a catastrophic event can cause anyone to get behind. Quick action can often save your good credit.

Employer-owned life insurance policies continued from other side

⇒ The total amount of insurance in force at the end of the year
⇒ Applicable contact information for the policyholder and the type of business in which the policyholder is engaged
⇒ Certification that a valid consent was obtained from each insured employee (or the number of employees for whom such consent was not obtained)

Form 8925 should be attached to the employer’s income tax return for each year ending after November 2007, in which there are employer-owned life insurance contracts issued after Aug. 18, 2006, in force. Please note that, even if the employee is an owner of the business, the above rules are applicable.

To bring a post-Aug. 18, 2006, EOLI policy into compliance and thereby avoid income tax on the portion of the proceeds in excess of cost basis, a new policy must be issued or an existing policy must be reissued with a “material change” to the death benefit – in either case after the proper notice and consent form has been obtained from the insured employee.

The new guidance states that, if a Section 1035 exchange for a policy issued before Aug. 18, 2006, is made that includes a material modification of the policy, the notice and consent requirements will apply to the new policy. Thus, it may be possible to bring a noncompliant policy into compliance by making a 1035 exchange to a policy with an increased death benefit or other change that constitutes a material modification.

However, a death benefit increase made merely to meet the requirements of Section 7702, dealing with modified endowment contracts, will not be considered a material modification.

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 to follow the rules. These provisions are indeed traps for the unwary, and careful adherence to the notice and consent requirements is imperative. You do not want to find out that the life insurance proceeds the business just received are subject to income tax.