Small Businesses Face Little Known Life Insurance Tax Trap

by Ashlea Ebeling – June 14, 2012

Employers who carry key man insurance and other common forms of employer-owned life insurance need to watch out for a potentially costly trap. The problem is that if proper notice and consent forms aren't completed before the policy is issued, the death benefit is taxable, when it would normally be tax exempt.

"The result is draconian," says Jonathan Forster, a tax lawyer with Greenberg & Traurig in McLean, Va. "If you're expecting a death benefit of $10 million and the IRS says you owe taxes, giving up 50%, if you're a widow counting on these proceeds, that's devastating."

The issue harkens back to the 2006 Pension Protection Act, which included a provision meant to reign in so-called "janitor's insurance." Congress didn't like the idea that people were unwittingly being insured by big corporations. So it made certain employer-owned life insurance policies taxable. What's happened is that everyday business insurance policies have been inadvertently swept up by these new rules.

The 2006 legislation affects the majority of business insurance arrangements, like key man insurance, insurance funded buy-sell arrangements, and some executive compensation programs. Basically, whenever a business entity owns a life insurance policy, there's the potential for falling under the rules. Even families entities—a family limited partnership or a limited liability corporation—that owns life insurance could be at risk.

The new rules apply to policies issued after Aug. 17, 2006. Policies may be taxable if notice and consent requirements were not met before the policy was issued.

The problem is that a lot of these insurance policies are sold to small businesses. It's the policyholder's responsibility that these notice and consent rules be met, and business owners have a lot more to worry about than picky insurance rules. Say you and I are in business together and you're the top sales person driving growth and extremely valuable to the company. If you die, the company would be in big trouble. So the company buys an insurance policy on you. If I give you notice and you consent with a simple (and common) oral, "Sure," then there is a tax problem. In another common scenario, a small business buys life insurance to make sure if a shareholder dies, the corporation can acquire the shares of the deceased from the family by using the proceeds of the insurance policy.

"The insurance agents didn't know; carriers said they didn't know; no one knew," says Forster. He recently had a conversation with a hedge fund owner who bought $100 million corporate owned life insurance on his partner but hadn't complied with these rules, and is considering his options to ensure that the death benefit would not be taxable. What are his options?

Going back to the carrier to get the policy reissued is one cure. You can try cancelling the original policy and issuing a new one. But if the employee has had health issues in the interim, they may not be insurable any more.

Applying to the Internal Revenue Service for a private letter ruling is another option. In a recent private letter ruling, PLR 201207017, the IRS ruled that an employer satisfied the notice and consent requirements although there was no separate form because the totality of other documents– "considering all of Taxpayer's documentation as a whole"— covered all the bases. One downside of a PLR is the expense: $18,000 just for the filing fee.

Doing nothing is a gamble you probably don't want to take. "Someone is going to get hurt in one of these for sure," Forster predicts.

Going forward, if you're buying a new policy, the solution is easy. If there is any doubt that it might be considered an EOLI policy, you clearly want a separately executed notice and consent form from the insured employee, so there is no question about compliance—and the ultimate tax-free nature of the benefit.