

Maintaining tax-free status of company-owned life insurance contracts



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Companies have historically purchased life insurance contracts on the lives of the owners or other important members of management. The proceeds have typically been used to purchase the owner's interest in the company from his or her heirs or retained by the company to help cushion the financial impact of the loss of a key employee. The proceeds of such life insurance policies were generally not taxable to the company.

As a result of certain laws and regulations, companies now have to take additional steps in order to maintain the tax-free status of life insurance proceeds.

Companies are obligated to keep records proving that certain "notice and consent requirements" have been met. The employer is required to notify the employee in writing that a policy will be issued on his or her life, the maximum face amount for which the employee could be insured, and that the company will be the beneficiary of any proceeds payable upon the employee's death. The employee has to provide written consent to being insured under the contract and allow such coverage to continue if he or she should terminate employment. The notice and consent must be dated prior to the issuance of the policy.

In addition to the notice and consent requirement, employers have to now disclose certain information with the company's federal tax return. The information must include the number of company employees at the end of the year, the number of employees insured by the company, the total amount of insurance in place at the end of the year, and whether or not the company has obtained a valid consent from each insured employee.

The above rules are effective for all employer-owned life insurance contracts issued after August 17, 2006. Failure to comply with the above requirements could result in serious negative income tax implications.

The above is a general overview of these rules. If you want to discuss the application of these rules to your company's situation, please contact us at 410.685.5512 or gma@gma-cpa.com.