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***56** PENSION PROTECTION ACT LAYS A TRAP FOR SOME INSURANCE-FUNDED BUY-SELL AGREEMENTS

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Many buy-sell agreements are funded by insurance on the lives of the business owners, to pay for the purchase of the interests at the insured's death. The amount of insurance bought to fund such agreements is based on the assumption that the proceeds will be received by the buying parties free of income tax. The validity of this assumption may have been jeopardized by a provision of the Pension Protection Act of 2006 (the 'Pension Act'), [FN1] signed by the President on 8/17/06.

COLI problems

Several federal courts have, in recent years, questioned both the tax and non-tax implications of certain company-owned life insurance ('COLI') arrangements, under which large employers, such as Wal-Mart and Dow Chemical, bought policies insuring the lives of thousands of rank-and-file employees, naming the employer as the beneficiary. These purchases were made without informing the employees about the insurance or without obtaining their consent, and the policies were maintained even after the insureds had terminated their employment with the policyowner.

The courts have repeatedly held that the employers have no right to the death benefits, because they lack an insurable interest in the lives of rank-and-file employees. [FN2] The courts have also held that the corporations were not entitled to federal income tax deductions for interest paid on loans secured to buy and maintain the policies. [FN3]

Congress enacted new Code Section 101(j) as part of the Pension Act. That subsection is intended to discourage corporations from buying insurance on rank-and-file employees without both notice and consent. Unfortunately, this same provision can create problems with insurance bought by a corporation on the life of a stockholder who is also an employee, officer or director, even if the insurance is used to fund the purchase of a deceased stockholder's shares. [FN4]

New Section 101(j)

Section 101(j)(1) states that the proceeds received on an 'employer-owned life insurance contract' are taxable as ordinary income, to the extent they exceed the policyowner's premium payments and other costs of policy ownership. Section 101(j)(3)(A) defines an 'employer-owned life insurance contract' as a life insurance contract that: (1) is owned by and benefits (directly or indirectly) someone engaged in a trade or business or a related person, and (2) insures the life of an individual who is employed with respect to the applicable policyholder's trade or business on the date the contract is issued. [FN5] An 'applicable policyholder' is the person (or related person) who owns the contract, as long as that person is both engaged in a trade or business, and is (directly or indirectly), or is related to, a beneficiary under the contract. [FN6]

There are two exceptions to the general rule that the proceeds of a COLI policy are includable in the applicable policyholder's gross income. First, the applicable policyholder's gross income does not include any amount received because of the death of an insured, if that amount is paid to a member of the insured's family, [FN7] an individual designated beneficiary of the ***51** insured under the contract (other than the applicable policyholder), or a trust created for the benefit of any member of the family of the insured or any individual who is the designated beneficiary under the contract (other than the applicable policyholder). [FN8]

Second, the gross income of an applicable policyholder does not include amounts received because of the death of an insured who was employed by the applicable policyholder at any time during the year ending on the date of death, or was a director, highly-compensated employee, [FN9] or highly-compensated individual [FN10] with respect to the applicable policyholder [FN11] on the date the policy was issued. This exception, therefore, excludes proceeds from gross income where the insured was an employee of the policyholder at any time during the 12-month period before his or her death, or the insured was a director, a 5%-or-greater owner of the business at any time during the preceding year, a person who has received compensation in excess of $95,000 (adjusted in the future for inflation) in the preceding year, one of the five highest-paid officers, or among the highest-paid 35% of all employees.

These exceptions apply only if notice is given to, and consent obtained from, the insured. Specifically, before the contract is issued, the insured employee must:

1 be notified in writing that the applicable policyholder intends to insure the employee's life, the maximum face amount for which the employee could be insured, and that the applicable policyholder will be the beneficiary of the death benefits; and

2 consent in writing both to being insured on such terms and to having coverage continue after the insured's employment terminates. [FN12]

Effective date

The new rules of Section 101(j) apply to contracts issued after the date of enactment; they do not apply to a contract issued after that date pursuant to a Section 1035 exchange for a contract issued on or before that date. [FN13]

Application to buy-sell agreements

This new rule may create serious problems for certain insurance-funded redemption buy-sell agreements. Shareholders who are parties to such agreements are often also employees, officers, or directors of the corporation. Under this new rule, the proceeds of the insurance policies on their lives will be ordinary income, unless the notice and consent requirements have been met. Often, such notice and consent will not be given and obtained, either because the parties are unaware that these new rules apply, or because the corporation simply does not know how much insurance it will need, because the insurance coverage will be periodically adjusted to reflect the changed value of the corporation's stock.

Practitioners now should make a notice and consent part of the buy-sell agreement itself.

These agreements are almost always executed before the insurance is actually purchased, and so can constitute a good means of providing the required notice and obtaining the required consent. A sample notice and consent provision follows:

> **Sample notice and consent provision of corporate redemption buy-sell agreement:**
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> **___ Notice and Consent.** This Section constitutes written notice to each shareholder that the corporation intends to insure the shareholder's life, the maximum face amount for which the shareholder may be insured, and that the corporation shall be the beneficiary of the death benefits under all such insurance policies. The signature of each shareholder to this agreement constitutes a written consent to being insured on such terms and that such coverage may continue even if any employment of the shareholder with the corporation shall have hereafter been terminated, regardless of cause and regardless of whether the termination shall have been by the unilateral decision of the corporation, the unilateral decision of the shareholder, or by mutual consent of the corporation and the shareholder.

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[FN1]. Pub. L. No. 109-280, 109th Cong., 2nd Sess. (2006). For more on company-owned life insurance under the new legislation, see Magner and Leimberg, 'Pension Protection Act Adopts Far-reaching New Rules for COLI,' p. 3, this issue.

[FN2]. See Rice v. Wal-Mart Stores, 2003 WL 22240349, 31 EBC 1876 (DC N.H., 2003); and Mayo v. Hartford Life Ins. Co., 354 F.3d 400 (CA-5, 2004), aff'g 220 F.Supp. 2d 714 (DC Tex., 2002); Tillman v. Camelot Music, Inc., 408 F.3d 1300 (CA-10, 2005). See also Leimberg and Zaritsky, Tax Planning With Life Insurance ¶1.14[7].

[FN3]. See Winn-Dixie Stores, Inc., 113 TC 254 (1999), aff'd 254 F.3d 1313, 87 AFTR2d 2001-2626 (CA-11, 2001), cert. den.; IRS v. CM Holdings, Inc., 254 B.R. 578, 86 AFTR2d 2000-6470 (DC Del., 2000), aff'd 301 F.3d 96, 90 AFTR2d 2002-5850 (CA-3, 2002); American Electric Power, Inc., 136 F.Supp. 2d 762, 87 AFTR2d 2001-917 (DC Ohio, 2001), aff'd 326 F.3d 737, 91 AFTR2d 2003-2060 (CA-6, 2003), reh. denied, 338 F.3d 534 (CA-6, 2003), cert. den.; Dow Chemical Co., 435 F.3d 594, 97 AFTR2d 2006-671 (CA-6, 2006), rev'g 250 F.Supp. 2d 748, 91 AFTR2d 2003-1489 (DC Mich., 2003), modified by, 278 F.Supp. 2d 844, 92 AFTR2d 2003-6418 (DC Mich., 2003). See also Leimberg and Zaritsky, Tax Planning With Life Insurance ¶2.09[3][b].

[FN4]. Technically, Section 101(j) can also create problems for a partnership entity buy-sell agreement that is funded with life insurance, though it is less likely that a partner will also be an employee of a partnership, than that a stockholder will also be an employee of a corporation, because a partnership does not need a wage-expense deduction to avoid current tax on its income.

[FN5]. An 'employee' includes 'an officer, director, and highly compensated employee.' Section 101(j)(5)(A). An 'insured' means an individual U.S. citizen or resident alien who is covered by a life insurance contract, and multiple such persons who are so covered. Section 101(j)(5)(B).

[FN6]. Section 101(j)(3)(B). A 'related person' includes any person who bears a relationship specified in Section 267(b) or 707(b)(1) or who is engaged in a trade or business that is under common control (within the meaning of Section 52(a) or 52(b)). These relationships include specified relationships among family members, shareholders and corporations, corporations who are members of a controlled group, trust grantors and fiduciaries, tax-exempt organizations and persons that control such organizations, commonly controlled S corporations, partnerships and C corporations, estates and beneficiaries, commonly controlled partnerships, and partners and partnerships.

[FN7]. A 'member of the family' is defined with reference to Section 267(c)(4), which includes the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

[FN8]. Section 101(j)(2)(B)(i). This exception also includes death benefits used to purchase an interest (including partnership capital and profits) in the employer from any of the preceding persons. These amounts must be paid or used by the due date of the tax return for the taxable year of the applicable policyholder in which they are received as a death benefit under the insurance contract so that the payment of the amount to such a person or persons, or the use of the amount to make such a purchase, is known in the taxable year for which the exception from the income inclusion rule is claimed.

[FN9]. 'Highly compensated employee' is defined with reference to Section 414(q) (but without regard to Section 414(q)(1)(B)(ii)), relating to the non-discrimination rules for qualified retirement plans. Thus, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if the employee (1) was a 5% owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $95,000 (for 2005) or (b) at the election of the employer, had compensation in excess of $95,000 (for 2005) and was in the highest paid 20% of employees for such year. The $95,000 dollar amount is indexed for inflation.

[FN10]. 'Highly compensated individual' is defined with reference to Section 105(h)(5), relating to medical reimbursement plans, substituting 35% for 25% in that subsection. Accordingly, a highly compensated individual is an employee who is one of the five highest paid officers of the employer, a shareholder who owns more than 10% of the value of the stock of the employer, or is among the highest paid 35% of all employees.

[FN11]. Section 101(j)(2)(A).

[FN12]. Section 101(j)(4).

[FN13]. Certain material increases in the death benefit and other material changes will cause the contract to be treated as a new contract, except that the addition of covered lives to a master contract is treated as a new contract only with respect to the additional covered lives. Policyholder dividends paid under some contracts may be applied to buy paid-up additions, which increase the death benefit. The insurer's consent is not required for these death benefit increases. For variable contracts and universal life contracts, the death benefit may increase as a result of market performance or the contract design. Certain other changes to a contract will not be considered material changes so as to cause a contract to be treated as a new contract. These safe harbor changes include administrative changes, changes from general to separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued. Staff of the Joint Committee on Taxation, 109th Cong., 2nd Sess., 'Technical Explanation of H.R. 4, The ' Pension Protection Act of 2006,' As Passed by the House on July 28, 2006, and As Considered by the Senate on August 3, 2006,' at 212-213 (2006) (Committee Print.).

33 Est. Plan. 56, 2006 WL 2735243 (W.G.&.L.)

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