Weatherby & Associates, PC
Counselors at Law
Helping Families Preserve and Protect Assets and Values

Henry C Weatherby*+
Jeffrey S. Rivard***

Joseph D. Farrell, of Counsel**

**Also Admitted in MA, NJ, and ID*
**** Also Admitted in NY*

+Member National Academy of Elder Law Attorneys
***Also Admitted in CA*

April 15, 2008

THOUGHT YOU'D LIKE TO SEE THIS:

When your client approaches their estate planning professionals to implement a plan, they should expect the parts to work together to accomplish their goals and to address family issues, control issues, and taxes.

One of the great things about life insurance is that the death benefit is usually income tax free. However, if their beneficiary designation is not done right, it can drastically change the tax result and that could create a significant liability exposure for the advisor who was involved in designating the beneficiary.

Ownership and Beneficiary Do Not Match

In general, if you own a life insurance contract, you can name anyone you want as the beneficiary of your contract, while still keeping the death benefit income tax free.

If a third party such as a spouse, adult child, business, or trust owns the policy on your life, the third party must name herself, himself, (or itself) the beneficiary of the policy. If there's a mismatch, it creates tax trouble.

For example, say that Ben's company owns a life insurance contract on Ben's life. The company names Ben's wife the beneficiary of the policy's death benefit. At Ben's death, the death proceeds will be treated as a taxable distribution to Ben's wife. The result could be treated either as compensation or in some cases as a dividend depending on the facts.

Likewise, in a personal situation, say that Cathy owns a life policy on her husband Paul's life. Cathy decides that in the event of Paul's death, she doesn't need the death proceeds. Cathy names their son Brandon as the beneficiary. At Paul's death, Cathy will be considered to be making a taxable gift to Brandon. While that doesn't expose the death proceeds to income taxes, it does make them subject to gift taxes. In some cases, the gift tax exposure might be a worse tax result than income tax inclusion.

So the rule of thumb is that if a third party owns a life contract on your life, the same third party should be the beneficiary.

New and Dangerous Code Section

The Pension Protection Act of 2006 created a new and very unpalatable general rule; **life insurance death benefits on an employee's life payable to the business are income taxable at ordinary income rates!**

The tax free death benefit can be preserved if

- proper notice and consent forms are obtained before the coverage is issued, and
- if the employee is:

  (1) a director of the employer company,
  (2) a 5-percent or greater owner of the employer company at any time during the preceding year,
  (3) a recipient of more than $95,000 in compensation from the employer in the preceding year,
  (4) one of the five highest-paid officers of the employer, or
  (5) among the highest paid 35% of all employees of the employer

While in many cases it's possible to avoid the income taxes by having the proper forms signed and making sure required IRS reporting takes place, the rules are still new and often overlooked or misunderstood. If the requirements are not met, the income tax taint on the policy appears to be permanent and there are no rules that allow a post-issuance correction!

Because of the great risk associated with these new rules, we recommend that certain procedures be followed in every case where there's any chance an employer — no matter the legal form of the entity or how large or small the business — might be thought to benefit, directly as a beneficiary or indirectly, from a life policy. This includes the following situations that involve life insurance, although the list is by no means comprehensive:

- buy-sell funding
- key man insurance
- informal financing of deferred compensation
- split dollar
- VEBA or other welfare benefit plans

The bottom line is that your beneficiary designations must be carefully arranged to be sure that your client's overall estate planning objectives are met.

As always, please feel free to call to chat about these or other financial security issues of importance to you or your clients.

Sincerely,
Weatherby & Associates, PC

Henry C Weatherby