Individual Life Insurance

Insurance products issued by:
Minnesota Life Insurance Company
Securian Life Insurance Company

Key employee life insurance

Foreword to counsel and specimen documents

Tax considerations

This information is a general discussion of the relevant federal tax laws. It is not intended for, nor can it be used by any taxpayer, for the purpose of avoiding federal tax penalties. This information is provided to support the promotion or marketing of ideas that may benefit a taxpayer. Taxpayers should seek the advice of their own tax and legal advisors regarding any tax and legal issues applicable to their specific circumstances.

I. Introduction

Key employee life insurance is life insurance owned by an employer (or a company) on the life of one of its important employees. Key employee and key person are terms that are used interchangeably. The loss of a key employee or key person can cause serious problems to a business such as lost sales, lower earnings and profits, and added costs for hiring and training a replacement. The purpose of key employee life insurance is to provide the business with the funds necessary to help it operate smoothly after the death of a key employee. With key employee life insurance, the business is owner and beneficiary of the life insurance policy, and the death benefit is used for unexpected costs incurred by the business after the death of a key employee.

Life insurance owned by a business can serve other purposes beyond assisting with those general expenses. Business-owned life insurance can fund a stock redemption or entity purchase buy-sell arrangement if the insured is a business owner.[1] Generally, when a business owner has life insurance coverage the term key person is utilized, as many times owners are not employees of the company.

Life insurance owned by a business may also be utilized to informally fund a nonqualified deferred compensation or salary continuation plan. Providing a special benefit through an endorsement method split-dollar arrangement requires life insurance owned by a business. The ability to use key employee life insurance for multiple purposes is an added benefit of business-owned life insurance. However, the following foreword to counsel and related specimen documents are resources only for traditional key employee life insurance arrangements. Please refer to our other technical resources for further information on those additional planning concepts that are funded with business-owned life insurance.

1. In Connelly v. United States 144 SCT 1406 (2024) the Supreme Court addressed the narrow question of whether a corporation's fair market value, where the corporation has an obligation to redeem a decedent owner's shares, is impacted by "key person" life insurance proceeds received by the corporation and committed to funding the redemption for estate tax purposes. The Court unanimously held that the corporation's redemption obligation is not a liability that reduces the estate tax value of the decedent's shares and that the death benefits received by the corporation must be included as part of the estate tax valuation. Key employee life insurance paid to a company will be included in the value of the business for estate tax purposes when a key employee business owner insured dies.

II. Strategy/technique structure

Key employee life insurance can be simple to implement. The insured must first be provided with a written notice and sign a consent before the business purchases life insurance on the employee's life. See Section 101(j) — employer owned life insurance (EOLI) rules. The life insurance application form should be completed with the business named as the owner and beneficiary of the life insurance policy. The key employee signs the application form as potential insured. The client's insurance financial professional as well as the insurance company's underwriting department will help determine the appropriate amount of death benefit for each key employee insurance case.

Any type of life insurance policy can be used for key employee life insurance. In some cases, a newer start-up business may prefer using more affordable term life insurance. In other cases, the business may prefer owning a cash value policy with stronger guarantees and longer lasting coverage. There are no restrictions on the type of life insurance used by the business. The business may choose to use whole life insurance, universal life, indexed universal life or variable universal life insurance. Every situation is different and the needs of the business must be considered to determine which type of policy is best suited for key employee coverage.

III. Income tax implications

A. Taxation of the premiums

Premiums paid on a life insurance policy are not income tax deductible if the taxpayer is directly or indirectly a beneficiary under the policy.[2] Thus, any business purchasing key employee life insurance cannot take an income tax deduction for the premiums paid because the business is owner and beneficiary of the policy.

B. Taxation of the death benefit

The general rule is a death benefit from a life insurance contract is received income tax free.[3] However, taxation of the death benefit for a key person life insurance policy could result under the employer owned life insurance rules,[4] under the accumulated earnings tax,[5] or if a transfer for value has occurred and no exception to the transfer for value rule applies.[6]

i. Section 101(j) — Employer owned life insurance (EOLI) rules

The Pension Protection Act (PPA) of 2006 added sub-section (j) to Internal Revenue Code (IRC) Section 101.[7] This sub-section covers the treatment of certain employer-owned life insurance contracts and changed the general rule related to the tax-free nature of death benefits. Under this sub-section, death benefits for EOLI will be income tax free only under certain circumstances.

Section 101(j) has two main requirements. First, the employer must comply with notice and consent requirements before the policy is issued. Second, even when the notice and consent requirements are met, the death benefit will be income tax free to the business only in certain described situations. The penalty for not satisfying these rules is big — **the death benefit is taxable**.

The EOLI rules apply to any new EOLI policy issued after August 17, 2006, and to any older policy materially changed since then.[8] There is little guidance on what is considered a material change, though it is clear that a material increase in a death benefit is a material change. Internal Revenue Service (IRS) Notice 2009-48 provides some guidance on what is NOT considered a material change.

An increase in the death benefit resulting from the operation of Section 7702 or the terms of the contract, an administrative change, or a change resulting from the exercise of an option or right granted under the original contract are not considered material changes. A Section 1035 exchange of a contract with no increase in the death benefit is generally not a material change. In general, if a policy issued on or before August 17, 2006, is exchanged for a new policy with no other changes to the features of the policy, the change should not be considered material for purposes of these rules.[9]

III. Income tax implications (continued)

Policies subject to IRC Section 101(j)

The rules under IRC Section 101(j) apply to EOLI. Section 101(j)(3) defines those life insurance arrangements considered EOLI and subject to the rules. To be subject to these rules, the life insurance contract must meet this definition:

1. The policy is owned by a business,
2. The business is directly or indirectly a beneficiary of the policy, AND
3. The insured is one of the following: an employee of the business, a director of the business, an officer of the business or an owner of the business owning more than 5 percent of the stock or more than 5 percent of the interest in the business. A "5 percent owner" is defined as someone owning more than 5 percent of the business.[10]

By definition, almost every key employee life insurance policy will be considered an EOLI policy subject to the 101(j) rules.

The first requirement of 101(j) — notice and consent

To obtain an income tax-free death benefit for those EOLI policies subject to the rules, the employer must provide a written notice and obtain a signed consent from the insured before the policy is issued.[11] Providing the notice to and obtaining consent from the insured are the **employer's** responsibilities. The notice and consent document must be signed by the prospective insured and state all of the following:

- The employer's intent to insure the employee
- The maximum face amount of life insurance being purchased
- The employer will be a beneficiary of the policy
- The coverage may continue after the insured terminates employment
- The insured consents to this life insurance coverage[12]

The second requirement of 101(j) — status of insured or use of death benefit

The death benefit will **always** be income tax free under 101(j) if the notice and consent rules were met before the policy was issued **and** if one of the following apply:

- The insured was a director when the policy was issued
- The insured was an employee who was highly compensated under IRC Section 414(q) when the policy was issued
- The insured was one of the highest paid 35 percent of all employees when the policy was issued
- The insured was one of the five highest paid officers when the policy was issued
- The insured owned more than 5 percent of the business when the policy was issued
- The insured was a shareholder who owned more than 10 percent of the employer stock either actually or constructively, when the policy was issued
- The death benefit is paid to a member of the insured's family, to the insured's chosen beneficiary, or to the insured's trust or estate
- The death benefit is used to purchase an interest in the business[13]

III. Income tax implications (continued)

There is a potential tax trap for a rank-and-file employee who is not described in this list above. Even if the signed notice and consent was obtained before the policy was issued, for a policy on the life of an employee that does not fit into any of the items in the list above, the death benefit is tax free **only if the insured dies while employed or within 12 months after terminating or retiring from employment. If the rank-and-file employee dies 12 months and one day (or later) after leaving employment, the death benefit paid to the business is taxable even if the notice and consent forms were signed as required.**[14]

The tax reporting requirements of 101(j)

An employer must report annually to the IRS all life insurance policies subject to these rules by completing Form 8925 (available at irs.gov) and attaching it to its federal income tax return. The information required for the annual reporting on Form 8925 includes:

1. The number of employees the employer had at the end of the tax year.
2. The number of those employees insured at the end of the tax year under the policy holder's employer owned life insurance contracts issued after August 17, 2006.
3. The total amount of life insurance in force at the end of the tax year under those contracts.
4. Whether the employer has a valid signed consent form for all insured employees, and if all consents have not been obtained, the number of employees for whom such consent was not obtained.
5. The name, address, and taxpayer identification number of the employer and type of business the employer is engaged in.[15]

ii. Accumulated earnings tax

A C corporation may also be subject to a penalty tax if it accumulates earnings instead of distributing them. The accumulated earnings tax is on amounts accumulated in a corporation that are beyond what is considered for a reasonable business need. A total of $250,000 may be accumulated ($150,000 for service corporations such as law, engineering, health care, architecture, accounting, actuarial science, consulting or performing arts) without incurring this penalty tax. The tax is 20 percent of accumulated taxable income.[16]

In general, the accumulated earnings tax should not apply if income is retained to purchase key person life insurance if the insurance is for a valid business need. There is authority that life insurance purchased to compensate a corporation for loss of a key person's services through early death is a reasonable business need.[17] Thus, the purchase of most traditional key employee life insurance policies should not be subject to the accumulated earnings tax for a C corporation.

III. Income tax implications (continued)

iii. Transfer for value rule

Life insurance transferred to another party in a business setting can result in a hidden tax trap and a taxable death benefit under the so-called "transfer for value rule."[18] This rule would subject the death benefit less any consideration paid and less further premiums paid to federal income taxation. There are some exceptions to this rule, however, if the policy is transferred to a proper party. The proper party exceptions to the transfer for value rule are if the policy is transferred to:

1. The insured
2. A corporation if the insured is an officer or shareholder
3. A partnership if the insured is a partner
4. A partner of the insured

One other exception to this tax rule is if the basis in the policy for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor. Thus, if the policy is transferred by gift or through a tax-free corporate reorganization, the cost basis is carried over, and the death benefit would remain income tax free not subject to the transfer for value rule.[19]

A new purchase of a key employee life insurance policy would generally not be subject to the transfer for value rule. However, if an existing policy is transferred to a business for key employee life insurance, the rule would come into play. If the policy is transferred to a corporation and the insured is an officer or shareholder of the corporation, then an exception applies and the death benefit would remain income tax free under this rule. If the policy is transferred to a partnership and the insured is a partner, then an exception applies and the death benefit would remain income tax free under the rule. The problem exists if the insured is someone who is not a partner of the partnership, or someone who is not a shareholder or officer of a corporation, and the policy is transferred to the respective partnership or corporation. Under those circumstances, there is no exception to the transfer for value rule and the death benefit would be income taxable.[20]

IV. Estate tax implications

If life insurance is owned by and payable to a business, the general rule is that the death benefit is not included in the insured's estate unless the insured possessed an incident of ownership in the policy.[21] Incidents of ownership include the right to change the beneficiary, to surrender the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain a policy loan.[22] This general rule of non-inclusion in the insured's estate applies to C corporations, S corporations, partnerships and LLCs. The rule applies if the insured is an owner of the business. The value of the business is separately included in an owner's estate. However, the death proceeds on a policy owned by the business and insuring the business owner will be reflected in valuing the business in the business owner's estate. Unless there is a buy-sell agreement, which removes the insurance from the estate the value of the business in the insured owner's estate will be increased by the death benefit received by the company.[23]

If the insured is a controlling shareholder, and if any part of the death benefit is not payable to the corporation, the death benefit payable outside of the corporation will be included in the insured shareholder's taxable estate.[24] A controlling shareholder is defined for this purpose as one who owns stock with more than 50 percent of the total combined voting power of the corporation.

In general, with most traditional key employee life insurance policies when the business owns and controls the policy and is named the sole beneficiary of the policy, the death benefit is not included in the insured's taxable estate, but the value of the business is increased by the amount of death benefit proportionately owned based on the share of the business owned.

Employer Owned Life Insurance Policy
Insured's Acknowledgment of Disclosure and Consent

Minnesota Life Insurance Company - a Securian Financial company
Life New Business • 400 Robert Street North • St. Paul, Minnesota 55101-2098

Employee/Proposed Insured - Information (please print)

Name			Date of birth
Address	City	State	Zip code
Telephone number			

Employer Information

Legal name			
Address	City	State	Zip code
Telephone number			

I, the employee/proposed insured, acknowledge disclosure and consent that:

- The employer intends to insure my life.
- I authorize and allow the employer to purchase such life insurance on my life.
- The maximum face amount for which I will be insured is: $_____________
- The employer will be the beneficiary of all or part of the life insurance policy proceeds.
- Such life insurance coverage may continue after my employment with employer has terminated.
- I have received this written Acknowledgment of Disclosure and Consent form from the employer.

Signature of employee/proposed insured	Date
X	

Employer - please review the following:

- This form must be executed and signed before the policy is issued.
- The execution of this form must involve an appropriate insured under IRC Section 101(j).
- Copies of this Acknowledgment of Disclosure and Consent form are retained by the Employer.
- For survivor life insurance policies, a separate form must be completed and retained for each of the proposed insureds.
- This form and information is not intended as tax, legal or accounting advice. It is provided only as a convenience. Taxpayers should consult with their own legal counsel for guidance in order to determine IRC Section 101(j) requirements and whether a specific planning strategy is suitable for any particular individual.

Corporate Resolution Authorizing Key Employee Life Insurance

I, ______________________________, secretary of ____________________________, a corporation duly organized and existing under and by virtue of the laws of the state of __________________, do hereby certify:

That on the ___________________ day of _________________, 20________, a meeting of the Board of Directors of said Corporation was duly called and held at _______________________________, at which a quorum was present, and the following resolution was unanimously adopted by said Board of Directors, to wit:

Whereas: The loss of ______________________'s services to the Corporation by reason of his or her death (or long-term disability) would seriously disrupt the operation of the business, cause an immediate loss of earnings and further losses in earnings inherent in securing and training a successor; and

Whereas: The Corporation desires to indemnify itself against such losses;

Therefore, be it resolved: That the Corporation does hereby approve and ratify the purchase of a [insert name of insurance company] life insurance policy (with a disability waiver policy rider)* from ____________________________ upon the life of _______________________________ in the amount of $_______________ with the Corporation designated as owner and beneficiary; and

Be it further resolved: That the Corporation shall maintain the above life insurance policy in full force and effect and shall pay all premiums when due; all rights and benefits accruing from the policy shall belong solely to the Corporation, and

_____________________________________(name of insured) shall have no interest whatsoever in the insurance contract; the cash value of the policy, if any, shall be carried on the books of the Corporation as an unassigned asset and the Board of Directors shall have the right to assign, encumber, sell or dispose of the policy in any manner it may please and to receive any value of the policy for the benefit of the Corporation.

In **witness whereof**: I have hereunto set my hand and the seal of the Corporation in the city of, ______________________ state of _____________, on this day of ________.

____

Signature

Corporate seal and/or other formalities in compliance with local law.

*The wording used should coincide with the features and riders to be added to the policy.

1. Connelly v. US, 144 US 1406 (2024)
2. IRC §264(a)(1).
3. IRC §101(a)(1).
4. IRC §101(j).
5. IRC §531.
6. IRC §101(a)(2).
7. PPA §863.
8. PPA §863(d).
9. IRS Notice 2009-48.
10. IRC §§101(j)(3), 101(j)(5)(A), 414(q).
11. IRC §101(j)(4).
12. Id.
13. See IRC §§101(j)(2)(A), 101(j)(2)(B), 414(q), 105(h)(5).
14. IRC §101(j)(2)(A)(i).
15. IRC §6039I; Treas. Reg. §1.6039I-IT.
16. IRC §531.
17. See Harry A. Koch v. Vinal, 13 AFTR 2d 1241 (D. Neb. 1964); see also Emeloid Co. v. Commissioner, 189 F.2d 230 (3rd Cir. 1951).
18. IRC §101(a)(2).
19. Id.
20. Id.
21. IRC §2042.
22. Treas. Reg. §20.2042-1(c)(2).
23. IRC §2703(b), Connelly v. US, 144 US 1406 (2024).
24. Treas. Reg. §20.2042-1(c)(6).

Please keep in mind that the primary reason to purchase a life insurance product is the death benefit.

Life insurance products contain charges, such as Cost of Insurance Charge, Cash Extra Charge, and Additional Agreements Charge (which we refer to as mortality charges), and Premium Charge, Monthly Policy Charge, Policy Issue Charge, Transaction Charge, Index Segment Charge, and Surrender Charge (which we refer to as expense charges). These charges may increase over time, and these policies may contain restrictions, such as surrender periods. Policyholders could lose money in these products.

Insurance policy guarantees are subject to the financial strength and claims-paying ability of the issuing insurance company.

Policy loans and withdrawals may create an adverse tax result in the event of lapse or policy surrender, and will reduce both the surrender value and death benefit. Withdrawals may be subject to taxation within the first 15 years of the contract. You should consult your tax advisor when considering taking a policy loan or withdrawal.

This is a general communication for informational and educational purposes. The information is not designed, or intended, to be applicable to any person's individual circumstances. It should not be considered investment advice, nor does it constitute a recommendation that anyone engage in (or refrain from) a particular course of action. If you are seeking investment advice or recommendations, please contact your financial professional.

Insurance products are issued by Minnesota Life Insurance Company in all states except New York. In New York, products are issued by Securian Life Insurance Company, a New York authorized insurer. Minnesota Life is not an authorized New York insurer and does not do insurance business in New York. Both companies are headquartered in St. Paul, MN. Product availability and features may vary by state. Each insurer is solely responsible for the financial obligations under the policies or contracts it issues.

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