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COLI Best Practices Provisions of the Pension Protection Act of 2006

The Pension Reform Act of 2006 was signed into law on August 17, 2006. It includes the industry-supported "COLI Best Practices" provisions regarding what causes the death proceeds under "employer-owned life insurance contracts" to lose the income tax exclusion under IRC Section 101(a)(1). The new rules offer clear guidelines for making sure that employer-owned life insurance contracts continue to provide tax-free death benefits to the employer.

Note: The new rules are effective for policies issued after August 17, 2006, except for policies issued after the date in a Section 1035 exchange for a policy issued on or prior to that date.

The following is a summary of the new rules:

The first industry "best practice" that has been incorporated into the new rules relates to notice and consent. To obtain a tax-free death benefit, the new law requires that, before the policy is issued, every proposed insured (i) be notified of the employer's intent to purchase the insurance and the maximum face amount to be purchased, (ii) provide his or her written consent to being insured and to such coverage continuing after termination of employment, and (iii) be informed that the employer will be a beneficiary of the death proceeds. If the notice and consent requirement is satisfied, and either one of the following two "best practices" rules is satisfied, the death proceeds payable to the employer or other applicable policyholder will be fully excluded from gross income under IRC Section 101(a)(1).

Note: It has always been a "best practice" for most employers to notify and obtain the consent of employees whose lives are insured under employer-owned policies. Now that practice is a requirement for the income tax exclusion of the death proceeds.

The second industry "best practice" that is incorporated into the new rules relates to the status of the employees who are covered. Assuming the notice and consent requirement is met, as long as (i) the insured was an employee at any time during the 12-month period before the insured's death, or (ii) the insured, at the time the policy was issued, was a director, a highly compensated employee (5% owner or earning more than \$95,000, for 2005, adjusted for inflation), or a highly compensated individual (one of five highest-paid officers or one of highest paid 35% of employees), then the death proceeds payable to the employer or other applicable policyholder will be fully excluded from gross income under IRC Section 101(a)(1).

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Note: Policies on rank-and-file employees will not provide tax-free death benefits for the employer after 12 months following termination of employment. For directors, highly compensated employees, or highly compensated individuals at time of issue, the proceeds will be tax-free to the employer regardless of what the insured's status is at death.

If employer-owned life insurance informally funds a nonqualified deferred compensation plan, and the employer keeps the policy in force after the executive's retirement for cost recovery purposes, those proceeds will be income-tax free at the executive's subsequent death as long as the executive was a director, highly compensated employee or highly compensated individual when the policy was issued. This is most likely given the "top hat" requirements applicable to such plans.

The third industry "best practice" that is incorporated into the new rules relates to the employer's use of the death proceeds. Regardless of the insured's status, again assuming the notice and consent requirement is met, to the extent that the employer pays those proceeds (i) to a member of the insured's family, (ii) to any individual who is a designated beneficiary of the insured with respect to such proceeds, (iii) to a trust for the benefit of a family member or designated beneficiary of the insured, or (iv) to the insured's estate, then the death proceeds will not be taxable to the employer.

The death proceeds will also not be taxable to the employer to the extent that they are used to purchase an equity (or capital or profits) interest in the employer or other applicable policyholder from a person listed above, i.e., family member, designated beneficiary, trust for their benefit, or the insured's estate.

Note: Life insurance funded "entity purchase" or "redemption" buy-sell agreements fall within the foregoing provision.

The new law requires annual reporting and record keeping by employers or other applicable policyholders, including the total number of employees, the total number of employees being insured, the total amount of insurance in force, the name, address and taxpayer identification number of the applicable policyholder and the type of business in which it is engaged, and a statement that there are valid consents or, if not, the total number of insureds for whom such consents were not obtained.