Because You Asked

Advanced Markets

Requirements for employer-owned life insurance

Special rules apply to employer-owned life insurance policies ("EOLI"). These rules were enacted as a result of the Pension Protection Act of 2006 and have been promulgated in Internal Revenue Code §101(j). It is important for business owners and their financial professional be familiar with these EOLI rules, because failure to comply may subject the death benefit, less premiums paid, to income-taxes. This piece will cover the obligations by the employer to keep the death benefit proceeds income tax-free.

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1. What constitutes EOLI for the purposes of §101(j)?

For the purposes of §101(j), a policy is "employer-owned" if it is a policy owned by a person or entity engaged in a trade or business on the life of an employee and that person/entity is directly or indirectly a beneficiary of the policy. IRC §101(j) applies to, but is not limited to, life insurance owned by a business to informally fund a non-qualified deferred compensation plan, key person insurance, entity purchase buy-sell arrangements, certain types of split dollar arrangements and insurance owned by a partnership or a sole proprietorship. The definition of EOLI was further clarified in IRS Notice 2009-48 and excludes policies owned by a business owner or a qualified plan. Additionally, the rule does not apply to policies on the lives of nonresident aliens.

2. What are the tax consequences for non-compliance with §101(j)?

Failure to comply with §101(j) subjects the entire death benefit, less premiums and other amounts paid by the policyholder, to income taxation.

3. How does an employer comply with §101(j)?

To ensure that the death benefit remains income tax-free, "Notice and Consent" requirements must be obtained *before* the policy is issued (see question 4).

If the Notice and Consent requirements are satisfied, an EOLI death benefit will generally be income tax-free in the following statutorily-defined situations:

A. The insured was an employee at any time during the 12 months preceding the insured's death (i.e., a "recent employee");

B. At the time the policy is issued, the insured is:

- a director,
- a highly compensated employee, as defined in §414(q) without regard to paragraph (1)(B)(ii); or
- among the highest paid 35% of all employees (i.e., a highly compensated individual, as defined in §105(h)(5));

C. The death benefit is paid to a member of the insured's immediate family, to the insured's designated beneficiary under the policy, to a trust for the benefit of a family member or designated beneficiary, or to the estate of the insured; OR

D. The death benefit is used to purchase an equity interest in the policyholder (employer) from a family member, beneficiary, trust, or estate.

Lastly as part of §101(j) compliance, the employer must include an informational filing, Form 8925, with its annual income tax return (question 6).

4. What are the "Notice and Consent" requirements?

The "Notice and Consent" requirements of §101(j)(4) are satisfied if, *prior to the issuance of the policy:*

A. The employer notifies the employee in writing that they intend to insure the employee's life and notifies them as to the maximum face amount which the employee could be insured at the time the contract was issued

B. The employee provides consent to being insured under the contract and understands that the coverage may continue after termination of employment

C. The employee is informed in writing that the employer will be a beneficiary of the policy

5. When is a policy considered to be "issued" for the purposes of §101(j)?

For the purposes of §101(j), the policy is "issued" on the later of:

A. The application;

B. The effective date of coverage; or

C. The formal issuance of the contract

6. What are the annual filing requirements for EOLI and the consequences for a failure to timely file Form 8925?

Under §6039I, employers that own EOLI policies must include an informational filing, Form 8925, with its annual income tax return. On Form 8925, the employer must list the number of employees, the number of EOLI policies, the total amount of EOLI death benefit, and the number of EOLI policies for which the employer has a valid Notice and Consent on file.

The IRS has not issued any definitive guidance on the penalty, if any, for failure to timely file Form 8925. However, it is most likely that any penalty resulting from this failure would be governed by IRC §6723, which imposes a $50 penalty for each instance of a failure to comply with "a specific information reporting requirement." Although there is a strong argument that failure to file Form 8925 does not alone cause the death benefit to become taxable under §101(j), clients should seek assistance from their tax professionals to determine how to proceed if such failure to file has occurred.

7. If changes are made to a policy that was issued before the effective date for §101(j), will the contract lose its "grandfathered" status?

IRC §101(j) applies to contracts issued after the date of the enactment of the Pension Protection Act of 2006 (i.e., August 17, 2006). Policies issued prior to that date are not subject to the provisions of §101(j) unless there has been a material change to the policy. Material increases in the death benefit or other material changes will cause the policy to be treated as a new contract that falls under the purview of §101(j).

Changes that are *not* considered "material" for the purposes of §101(j) include:

A. Increases in the death benefit resulting from the terms of the contract requiring no consent from the insurer or operation of §7702;

B. Administrative changes;

C. Changes between general and separate accounts; or

D. Changes resulting from exercise of an option or right under the original contract.

8. Must §101(j) be complied with if the employee transfers a policy to the employer?

The Notice and Consent requirements of §101(j) are waived if the employee irrevocably transfers an existing contract to the employer, presumably because the IRS figures that an employee who is transferring an existing contract to the employer has actual knowledge of the factors covered by the consent requirements. It is important to note that while the Notice and

Consent requirements are waived in this situation, for the employer to receive the death benefit income tax-free, the insured would have to fall into one of the categories listed in Question 3 above.

Note that if the employer, subsequent to the irrevocable transfer, increases the policy's face value, then the Notice and Consent requirements must be satisfied with respect to the policy.

9. Does a buy-sell arrangement satisfy the Notice and Consent requirements?

Possibly. In Private Letter Ruling (PLR) 201217017, a Corporation successfully argued that its buy-sell arrangement satisfied the requirements of §101(j) because under IRS Notice 2009-48 it had made a "good faith effort" to comply. In this ruling, the Corporation and several of its shareholders entered into a buy-sell arrangement. As part of the agreement, the Corporation purchased life insurance on the lives of the party shareholders and was the owner and beneficiary of the policies. Each insured shareholder completed and signed an application showing that Corporation would be the owner and beneficiary of the life insurance and the amount of coverage being purchased. The IRS held that in this case each party shareholder received sufficient notice to meet the requirements of §101(j)(4) through a combination of the written buy-sell agreement and the life insurance application. They also held that each shareholder indicated and provided consent through the act of signing said agreement and applications. Although PLRs are only binding authority for the taxpayer for whom they are issued and may not be cited as authority, this PLR indicates that Notice and Consent requirements may be satisfied by other means than just a standalone Notice and Consent form. However, as a best practice, employers who are purchasing life insurance on an owner/employee pursuant to a buy-sell agreement should still satisfy the requirements of §101(j) with independent documentation drafted specifically to do so.

10. When do split dollar contracts fall under the requirements of § 101(j)?

A contract that is subject to a split dollar agreement is an EOLI contract if the contract is owned by a person engaged in a trade or business. The obvious situation in which §101(j) would apply is the standard endorsement split dollar arrangement in which the employer owns the life insurance contract and endorses the death benefit to the insured employee (or the employee's family). Less obviously, §101(j) also applies to collateral assignment split dollar agreements between the employer and the employee (or the employee's trust) where the employee or the employee's trust owns the policy. This is because the split dollar rules in the Treasury Regulations under §61 say that the premium payor of a collateral assignment split dollar agreement is deemed to be the owner of that split dollar life insurance contract. This means that under the split dollar final regulations, the employer is treated as the owner of the split dollar life insurance contract, bringing that split dollar contract with the purview of §101(j).

11. Is there a way to "correct" a failure to provide Notice and Consent prior to issue?

Unfortunately §101(j) does not provide a way to correct noncompliance with the Notice and Consent requirements. However, IRS Notice 2009-48 indicates that there may be several potential remedies. Foremost, the IRS has stated that it will not challenge an inadvertent failure to satisfy the Notice and Consent requirement so long as:

A. the policy holder made a "good faith effort" to comply with the Notice and Consent requirements;

B. failure to satisfy the requirements was "inadvertent;" and

C. the failure to comply was noticed and corrected no later than the due date of the tax return for the taxable year of the policyholder in which the employer-owned policy was issued.

Increasing the death benefit on the policy may be another option to remedy §101(j) noncompliance (note that no guidance has been issued on how much of an increase is required). As discussed, Notice and Consent is required if a contract is treated as a new contract due to a material increase in death benefit or other material change. Similarly, a §1035 exchange which results in a "material change" will be treated as a new contract for the purposes of the §101(j) Notice and Consent requirements. Because the authority on remedying §101(j) noncompliance is unclear, it is important that clients consult with their tax/legal counsel for advice.

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