John Hancock INSURANCE

ADVANCED MARKETS

BECAUSE YOU ASKED

101(j) Requirements for Employer Owned Life Insurance

The Pension Protection Act of 2006 (PPA '06), which became law on August 17, 2006, included new rules on employer-owned life insurance that became effective for all employer owned life insurance policies issued or materially changed after August 17, 2006. If the employer-owned life insurance (EOLI) rules are not complied with, a portion of the death benefit received on the EOLI policy will be subject to income taxes. The EOLI rules created by the PPA '06 were incorporated into the provisions of Sections 101(j) and 6039I of the Internal Revenue Code.

In addition, on May 22, 2009, the IRS issued Notice 2009-48, which addressed several outstanding questions surrounding the treatment of employer-owned life insurance contracts under IRC §§101(j) and 6039I (requiring annual reporting on Form 8925).

TABLE OF CONTENTS

LIFE-7503 3/17

1. What constitutes "employer-owned life insurance" (EOLI) for the purposes of §101(j)?

An employer-owned life insurance contract is defined as a life insurance contract which:

- Is owned by a person (or entity) engaged in a trade or business and under which such person or a related person is directly or indirectly a beneficiary under the contract; AND
- The contract covers the life of an insured who is an employee with respect to the trade or business of the applicable policy owner on the date that the contract is issued.

The definition of "Employer Owned Life Insurance," was further clarified in IRS Notice 2009-48, stating that a policy is "employer-owned" for §101(j) purposes only if it is owned by a person engaged in a trade or business.[1] A policy that is owned by a business owner or a qualified plan (or VEBA) of an employer is not an EOLI contract for §101(j) purposes. An employer-owned policy subject to a split-dollar arrangement is subject to the provisions of §101(j), as is a life insurance policy owned by a partnership or a sole proprietorship.

Note that §101(j) does not apply to policies on the lives of nonresident aliens (individuals who are neither U.S. citizens nor U.S. residents).

2. What is §101(j) and how does it impact EOLI?

The general rule under IRC §101(j) is that death benefits received on employer-owned life insurance contracts are taxable to the employer to the extent the death benefit exceeds an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract. To receive death benefits without triggering the additional income tax imposed by IRC §101(j), two requirements must be satisfied: (1) Notice and Consent must be obtained before the policy is issued, AND (2) the insured must fall into one of the statutorily defined coverage conditions, or "exceptions" (see Questions 4 and 5, respectively).

If these two requirements are not satisfied, the death benefit on an EOLI policy in excess of the premiums and other amounts paid on the contract will be included in the employer's income.

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

To ensure the employer/applicable policyholder will receive the policy death benefit without triggering the additional income tax imposed by §101(j), the written Notice and Consent has to be put in place before the policy is issued. The employer must also 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. Employers that own EOLI contracts subject to §101(j) must maintain annual records to demonstrate that the requirements of §101(j) are met.

1. Unless otherwise noted, the answers to all of the questions discussed in this BYA are based on information provided in the applicable statutes or Notice 2009-48.

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

The Notice and Consent requirements of §101(j)(4) are met if, before the issuance of the policy, the employee (1) is notified in writing that the applicable policyholder intends to insure the employee's life and of the maximum face amount for which the employee could be insured at the time the contract was issued; (2) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment; and (3) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

The Notice and Consent must be obtained in writing *before* the policy is issued.

5. What are the statutory "exceptions" that must be satisfied?

In addition to satisfying the Notice and Consent requirements, in order for the employer to receive the death benefit income-tax free rather than triggering the income tax imposed by IRC §101(j), the insured must fall into one of the statutorily defined categories based on (1) the insured's status at the time the policy is *issued*, (2) death benefit payments payable to the insured's family, or (3) the insured being a recent employee as discussed below ("the exceptions").

The "exceptions" are as follows:

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:
   1) a director,
   2) a highly compensated employee, as defined in §414(q) without regard to paragraph (1)(B)(ii); or
   3) 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.

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

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

1. The application;
2. The effective date of coverage; or
3. The formal issuance of the contract.

7. What is the effective date for §101(j)?	Section 101(j) applies to contracts issued after the date of enactment of the PPA (August 17, 2006). Policies issued prior to August 17, 2006 are not subject to the provisions of §101(j) unless there has been a material change to the policy (see Question 8). An exception to this general rule is for contracts issued after August 17, 2006 pursuant to a §1035 exchange where there has been no material modification to the policy. Material increases in the death benefit or other material changes will cause a policy to be treated as a new contract and will require §101(j) compliance (see Question 8)
8. If changes are made to a pre-101(j) policy, will the contract lose its "grandfathered" status?	Possibly. Material increases in the death benefit or other material changes will cause a policy to be treated as a new contract which will fall under the purview of §101(j). The changes that are **not** considered material for purposes of §101(j) include: 1. Increases in death benefit resulting from the terms of the contract requiring no consent from the insurer or operation of §7702; 2. Administrative changes; 3. Changes between general and separate accounts; or 4. Changes resulting from exercise of an option or right under the original contract
9. Must §101(j) be complied with if the employee transfers a policy to his/her 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, the exceptions for possible insureds discussed in Question 5 are not also waived. Therefore, 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 5 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.

10. 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, 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 stand-alone 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.

11. 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).

12. 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 in Questions 7 and 8 above, 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.

13. What are the consequences for failing to file Form 8925 under §6039I?

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 advisors to determine how to proceed if such failure to file has occurred.

CONCLUSION

The provisions of §101(j) will potentially impact life insurance policies that are used in a variety of employee benefit and business planning arrangements, including nonqualified deferred compensation, key person insurance, some buy-sell agreements, certain types of split dollar agreements, and BOLI. Care should be taken to make sure that the requirements of §101(j) are met for any applicable case. Clients should consult their tax/legal/financial professionals for more information and advice.