ADVANCED MARKETS

A Guide to IRC §101(j) Compliance: Avoiding Potential Taxation of Employer-Owned Life Insurance

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AN INTEGRITY COMPANY

Employer-Owned Life Insurance

COMPLIANCE WITH IRC SECTIONS 101(J) AND 6039I

IRC Sec. 101(j) applies to policies issued after Aug. 17, 2006, (or issued pursuant to a 1035 exchange with material increases to the death benefit or material changes to the policy) in which a business (or a related party) is the owner of the policy, the business (or a related party) is directly or indirectly the beneficiary, and an employee is the insured.

The general rule is that death benefits paid from a life insurance policy subject to IRC Sec. 101(j) are taxable when received. In order to avoid taxation of the death benefits, you must qualify for one of the following **exceptions**:

- The insured is a director or highly compensated employee[1]
- The employee/insured was employed by the business no later than 12 months prior to death
- The death benefits are payable to the employee's heirs (family members, trust, estate)
- The death benefits are used to purchase an interest in the business

In addition to qualifying for an exception, the employer must provide the insured employee with **written notice** stating:

- That the business intends to insure the life of the employee and that coverage may continue after the employee terminates employment
- That the business will be the beneficiary of the life insurance policy
- The maximum amount of life insurance coverage the business will obtain on the employee

The insured employee needs to **consent in writing** to being insured and to having coverage continue after they terminate their employment **PRIOR TO ISSUANCE OF THE POLICY**.

General rule for Employer-Owned Life Insurance—death benefits are taxable as income unless you qualify for one of the exceptions.

*In order to avoid taxation of employer-owned life insurance death benefits, you are required to meet the notice and consent requirements **prior to issuance of the policy**.*

[1] The highly compensated requirement can be met by any of the following:
- Insured employee has compensation in excess of the 414(q) limit ($105,000 in 2008)
- Insured employee is among the top 35% in pay – IRC Sec. 105(h)
- Insured employee owns 5% or more of the business

In order to avoid taxation of the death benefits, the business also must **report to the IRS** (on IRS Form 8925):

- The number of employees of the applicable policyholder at the end of the year
- The number of such employees insured under such contracts at the end of the year
- The total amount of insurance in force at the end of the year under such contracts
- The name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged
- That the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained)

IRS NOTICE 2009-48

In June of 2009, the IRS published additional guidance on IRC 101(j) in the form of IRS Notice 2009-48. The Notice provides guidance in five different areas:

1. The definition of employer-owned life insurance
2. Exceptions to the application of 101(j)(1) – timing of the notice and consent requirement
3. Satisfaction of the notice and consent requirement
4. Transition rules and 1035 exchanges
5. Information Reporting under §6039I and Form 8925

One of the most frequently asked questions has been whether or not any relief is available for inadvertently failing to comply with the notice and consent requirements. The Notice stated the following:

> **Q:** How can an inadvertent failure to satisfy the notice and consent requirements of §101(j)(4) be corrected?
>
> **A:** Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of §101(j)(4). The Service will not, however, challenge the applicability of an exception under §101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met:

> *In order to avoid taxation of employer-owned life insurance death benefits, you are required to meet the reporting and record keeping requirements **after** issuance of the policy.*

> *Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of 101(j)(4).*

(1) The applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees;

(2) The failure to satisfy the requirements was inadvertent; and

(3) The failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee's consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

While Notice 2009-48 is effective June 15, 2009, the IRS will not challenge a taxpayer who made a good faith effort to comply with IRC §101(j) based on a reasonable interpretation of the statutory provision prior to the effective date.

> *An **inadvertent** failure to obtain notice and consent may be corrected before the tax filing deadline for the year the policy was issued—unless the insured employee has died.*

PLR 201217017

In Private Letter Ruling 201217017, the taxpayer requested a ruling from the IRS that the taxpayer did not violate the notice and consent requirement of IRC 101(j) because they had made a good faith effort to comply pursuant to Notice 2009-48.

The taxpayer (an employer) purchased insurance policies on shareholders of the business in order to fund a buy-sell agreement. The facts state that the taxpayer did NOT provide each insured with a separate document that contained all of the necessary notice and consent information. However, the IRS looked at the application for insurance along with the buy-sell agreement and determined that:

1. Through the buy-sell agreement and the life insurance application, each shareholder was notified in writing that the taxpayer (employer) intended to insure their lives;
2. Through the application, each shareholder was notified in writing of the maximum face amount for which the shareholder could be insured at the time the contract was issued, in dollars;
3. By signing both the buy-sell agreement and the life insurance application, each shareholder consented to being insured under the contract;

4. By signing the agreement, each shareholder consented that such coverage may continue after the shareholder terminates employment; and,
5. Through the agreement and the application, each shareholder was informed in writing that the taxpayer will be a beneficiary of any proceeds payable upon the death of the shareholder

Due to these findings of fact, the IRS ruled that the taxpayer had satisfied the notice and consent requirements of 101(j) **before** the policies were issued. It is important to consider a number of important facts regarding this guidance from the IRS:

1. There were specific provisions in the buy-sell agreement that led the IRS to determine that the shareholders consented that the coverage could be continued by the employer after they terminated employment, which is a requirement under 101(j). Many buy-sell agreements do not contain the language used in this buy-sell agreement and would therefore fail to meet this particular requirement.
2. While the employer did not obtain separate documentation from each shareholder that expressly complied with the notice and consent requirements PRIOR to the issuance of the policies, they did in fact obtain separate documentation after the policies were issued (but not before the due date of the taxpayer's federal income tax return). The fact that they did obtain the separate documentation most certainly helped the taxpayer in this case argue that they had acted in "good faith."
3. Private letter rulings are directed only to the taxpayer requesting them and cannot be used or cited as precedent for other taxpayers.

In order to avoid having the death benefits on employer-owned policies subjected to income taxes, it is highly recommended that employers comply with all of the notice and consent requirements of 101(j) **prior** to having life insurance policies covering the lives of employees issued, and comply with the reporting and record keeping requirements each year they continue to own any such policies.

EXHIBITS

Exhibit 1, Ash Employee-Owned Life Insurance (EOLI) Worksheet, can be used by your tax advisor to determine whether a given policy is subject to these requirements.

Exhibit 2, Ash EOLI Notice and Consent Form, is one example of a form that provides the employee with the required information. Note that as part of the process of underwriting a new policy, some life insurance carriers will provide a Notice and Consent form as a matter of convenience. In either case, it is ultimately the responsibility of the employer to be in compliance. Consult your tax advisor for guidance.

Exhibit 3, IRS Form 8925 - Report of Employer-Owned Life Insurance Contracts. This informational report is required to be filed with your tax return each year that your business owns policies on the lives of employees.

RELEVANT IRC SECTIONS

IRC Sec. 101(j)(3)(A)(i) – Employer-Owned Life Insurance

The term "employer-owned life insurance contract" means a life insurance contract which is owned by a person engaged in a trade or business and under which such person (or a related person described in subparagraph (B)(ii)) is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

IRC Sec. 267(b) - Relationships

The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

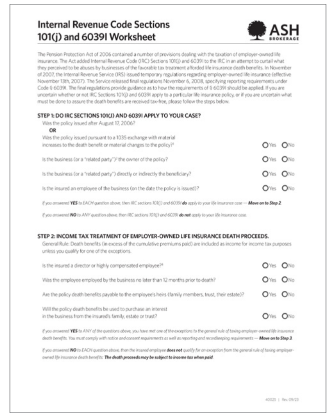
(10) A corporation and a partnership if the same persons own—

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

EXHIBIT 1:

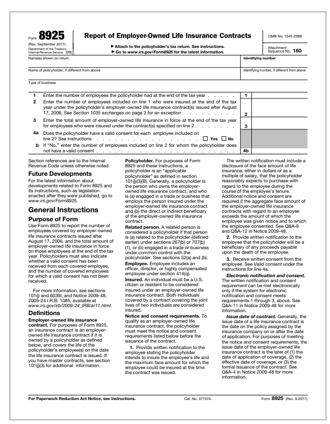
- Ash EOLI Worksheet Form 40025


Internal Revenue Code Sections 101(j) and 6039I Worksheet


101(j) Notice and Consent to Employers Application for Life Insurance

EXHIBIT 2:

- IRS Form 8925


Form 8925 Report of Employer-Owned Life Insurance Contracts

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

IRC Sec. 267(c)(4) – Family Defined

The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants.

IRC Sec. 707(b)(1) – Partner Relationships

(A) A partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests

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