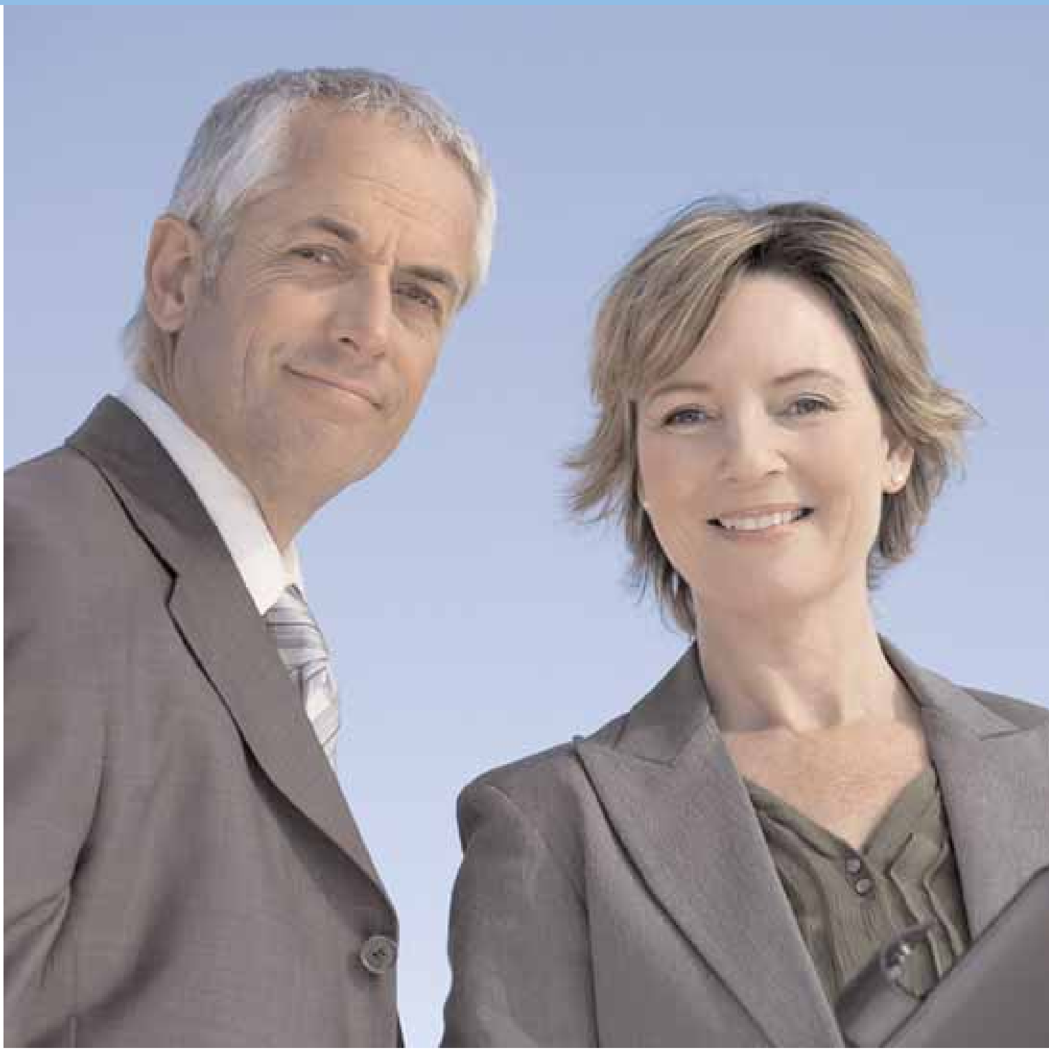
That New Law for Business Life Insurance: Understanding Section 101(j) and Repairing Noncompliance

Deep inside the offices of a major insurance carrier, a phone is ringing. On the other end of the line is the panicked voice of an agent:

"I just heard about that new law for business life insurance? What is it? How does it work? What if I've already sold insurance to a business**?**

Is it too late?"

Whether you call it § 101(j), COLI best practices, EOLI requirements, or the PPA rules, there is a new law on the books and it has the potential to create negative income tax consequences for your business clients. With the enactment of IRC § 101(j), the tax treatment for life insurance owned by a business has changed. Death benefits on policies insuring employees of a business will be taxed as income unless the new rules are followed. And since § 101(j) applies to all policies purchased on or after August 17, 2006, as well as to material modifications of policies purchased prior to that date, there may be good reason for some agents to be worried.



There is a new law on the books.

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Summary of IRC § 101(j)

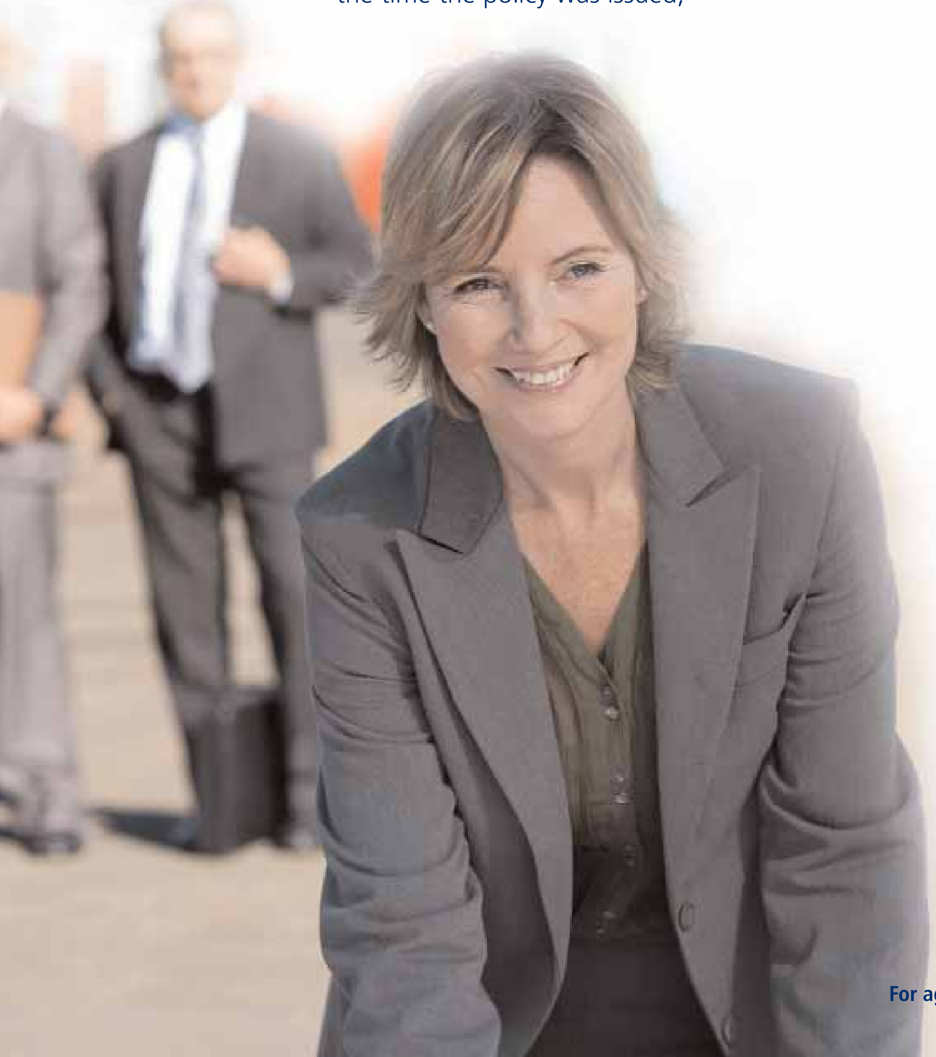
Section 101(j) was enacted as part of the Pension Protection Act ("PPA") which was signed into law on August 17, 2006. Under § 101(j), where the owner of a life insurance policy is a business and where the insured is an employee of the business, death benefits received by the employer may be excluded from gross income so long as two conditions are met: (i) the policy is held on an appropriate insured; and (ii) the employer satisfies all of the new disclosure and consent requirements. Where both of these conditions are met, death benefits from employer-owned life insurance ("EOLI") policies will continue to be excluded from the gross income of the business.

Appropriate Insureds

In order for death benefits to be excluded from gross income, an EOLI policy must relate to an appropriate insured. An EOLI policy involves an appropriate insured if any of the following conditions is met:

i. The insured was an employee at any time during the 12-month period prior to death;

ii. The insured was a director of the corporation at the time the policy was issued;



iii. The insured was a "highly compensated employee" (as defined in IRC § 414(q)) at the time the policy was issued;

iv. The insured was among the highest paid 35% of employees at the time the policy was issued;

v. The death benefit is used to pay benefits to the insured's heirs, estate, or a trust for the benefit of one or more members of the insured's family; or

vi. The death benefit is used to purchase an equity interest in the corporation from the insured's heirs, estate, or a trust for the benefit of one or more members of the insured's family.

Disclosure and Consent Requirements

In addition to meeting the proper insured requirements, a business must meet all of the following disclosure and consent requirements *prior to issue* of the EOLI policy:

i. The employee must be notified *in writing* that the corporation intends to insure the employee's life;

ii. The employee must be notified *in writing* of the maximum face amount for which the employer might insure the employee;

iii. The employee must be notified *in writing* that the corporation will be a beneficiary of some or all of the policy death benefits;

iv. The employee must give *written consent* to being insured by the corporation; and

v. The employee must give *written consent* to coverage continuing after employment with the corporation is terminated.

It is important to make sure that insured employees are getting notices and providing consent to all of the specific requirements set out in § 101(j). While many insurance carriers provide consent forms as part of the insurance applications, it is unlikely that these forms will satisfy § 101(j). It is especially unlikely that the insurance carrier's standard consent forms will provide specific notice about the maximum amount of insurance that an employer might apply for or that there will be a provision regarding the possibility of coverage continuing after employment is terminated. A better practice may be to have employees sign an additional notice and consent form that is designed specifically for § 101(j) and have the business maintain those forms as part of its records. Finally, keep in mind that these notice and consent provisions also apply to policies on business owners if the owner is also an employee of the business.

In sum, an employer may receive death benefits which are excluded from gross income if the policy meets at least one of the appropriate insured or permissible use requirements and if *prior to the policy's issue* the corporation has complied with *all* of the disclosure and consent requirements. Generally, the "appropriate insured" requirement will not be difficult to satisfy for EOLI policies. So long as the policy is being used for key-person insurance, "top hat" plans, employee benefits, estate planning for a business owner, or to fund business buy-sell arrangements, the policy will be held on an appropriate insured. What is new in § 101(j) are the **disclosure and consent requirements**. Agents and advisors must be diligent in helping business clients meet these requirements **before** a policy is issued.

Reporting Requirements

In addition to § 101(j), the PPA added new reporting requirements for EOLI policies by enacting IRC § 6039I. Under this new code section, a corporation which purchases life insurance on one or more of its employees after August 17, 2006 must report the following on an annual basis:

- The number of employees the corporation has at the end of the year;
- The number of those employees insured under EOLI policies at the end of the year;
- The total amount of EOLI insurance in force at the end of the year;
- The name, address, and taxpayer ID of the corporation and the type of business in which it is engaged; and
- A statement that the corporation has a valid consent for each insured employee (or the number of insured employees from whom consent has not been obtained).

In order to facilitate this reporting, the IRS has published Form 8925 which can be attached to the employer's annual income tax return.

Repairing Non-Compliant EOLI Arrangements

Section 101(j) can be an especially dangerous tax snare because all of its notice and consent provisions must be complied with *before* an EOLI policy is issued. What causes insurance agents to call the home office in a panic is the fact that many of them do not learn about §101(j) until after the EOLI sale has been completed. **Is it too late?**

Unfortunately, § 101(j) fails to provide a remedy for failure to meet the notice and consent requirements before a policy is issued. But it seems unlikely that Congress meant for such a failure to be irreparable. After all, the purpose of § 101(j) is to prevent employers from insuring employees without their knowledge or consent. It seems that late notice and consent would be preferable to none at all. But without any remedy provisions in the statute, what can businesses do to fix a noncompliant EOLI arrangement?

Understanding and Repairing

While the IRS has yet to provide any specific procedure for correcting defective EOLI arrangements, it has issued some guidance in Notice 2009-48 (the "Notice"). A business owner seeking to repair an EOLI arrangement may want to consult with a tax advisor to see if one of the following remedies might work: (i) reissue, (ii) increase, or (iii) transfer.

Depending on how soon the parties recognize that there has been a failure to comply with § 101(j), it may be possible to have the underlying EOLI policy reissued by the insurance carrier. Under § 101(j)(4), the notice and consent provisions must be fulfilled before the policy is *issued*. According to section A-4 of the Notice, a policy's issue date under § 101(j) is the later of (i) the date of application, (ii) the date coverage becomes effective, or (iii) the date of formal issuance. Thus, if the insurance carrier is willing and able to reissue the underlying EOLI contract, the parties may be able to meet the notice and consent requirements prior to the policy's reissue date.

A second possibility for fixing a § 101(j) problem is to increase the death benefit on the EOLI policy. "[A]n employer-owned life insurance contract may be treated as a new contract, and thus newly "issued," by reason of a material increase in death benefit or other material change in the contract." Notice 2009-48, A-4. Although it is not clear how much of an increase in death benefit is needed to make it a *material* increase, section A-14 of the Notice indicates that any increase which is not required under IRC § 7702 or which is not merely administrative may be material. Clients would need to consult with their own tax or legal counsel to make this determination.

Finally, it may be possible to rectify a § 101(j) omission by transferring the EOLI policy to the insured employee and subsequently having the employee transfer the policy to the business. The IRS indicates in section A-8 of the Notice that: "The actual transfer of an existing life insurance contract by an employee to an employer is sufficient to satisfy the requirements that the employee be notified in writing of the intention to insure and the maximum face amount of insurance, that written consent be secured, and that the employee be notified that the employer will be a beneficiary upon his or her death." If the parties can work out a way to make these transfers income tax-neutral (i.e., avoid a transfer for value and not create any unwanted income for the employee), then a sequential set of policy transfers may be able to satisfy the requirements of § 101(j).

Summary

Section 101(j) is a potential tax trap for any business purchasing life insurance on an employee or owner-employee. To avoid income taxation of death benefits, the insurance must be on an appropriate insured and all of § 101(j)'s notice and consent provisions must be met prior to issuance of the EOLI policy. Employers are also required to report EOLI holdings annually as part of the income tax return filed for the business. And while it may be difficult, business owners may want to consider strategies for amending defective EOLI arrangements to bring them into compliance with § 101(j).