Taxation Update | Key Person

IRC Section 101(j) Q & A

Q1. What is the general framework of new IRC Section 101(j)?

A1. The overall framework of IRC Section 101(j) imposes certain requirements, which if met, will generally allow death benefits of employer-owned life insurance to be received income tax free. Said another way, the general rule is that employer-owned life insurance death proceeds are taxable, to the extent they exceed cost basis, unless the requirements of 101(j) are met.

Q2. If the general rule of Section 101(j) is that employer-owned life insurance death proceeds are taxable, then how do death proceeds payable to an employer, from employer-owned contracts, qualify as tax-free under the general rule of IRC Section 101(a)?

A2. The first hurdle is that **the employer** must comply with the notice and consent requirement. In general, insureds will need to timely sign a written notice and consent form. Notice and consent details are provided in Q & As 13, 14, and 15. The other major requirement is that at least **one** of the specific exceptions to the general rule (covered in more detail below) must be met. These exceptions are based on either the **insured's status** with an employer or the fact that death proceeds are payable to, or for the benefit of, the **insured's heirs,** including purchase of an insured's equity interest in the employer as discussed below.

Q3. What are the exceptions based on an insured's status?

A3. The **insured's status** may be used as an exception under two different sets of circumstances. The first circumstance is that the insured was an employee within the twelve-month period preceding his or her **death**. The other circumstance focuses on the status of the insured **at the time the policy is issued**. This exception may be available if the insured is (1) a highly compensated employee (HCE) under IRC 414(q); (2) a highly compensated individual (HCI) as defined under IRC Section 105(h)(5) (as slightly modified by Section 101(j)); or, (3) a director of the employer.

Q4. What is the definition of a highly compensated employee (HCE) under IRC Section 414(q)?

A4. Under IRC Section 414(q), an HCE is someone who was either (1) a 5% owner (defined as a person who owns, including stock ownership attributed under Section 318, more than 5% of the outstanding stock or voting stock of a corporation or, if the employer is not a corporation, any person who owns more than 5% of the capital or profits interest in the employer) during the current or preceding year or (2) an employee with at least $115,000 (2014) of compensation for the preceding year. The income figure

may be is adjusted annually for inflation. A former employee may be considered a HCE if he or she separates from service as a HCE or was a HCE at any time after attaining age 55.

Q5. What is the definition of a highly compensated individual (HCI) under IRC Section 105(h)(5) as applicable to Section 101(j)?

A5. For purposes of IRC Section 101(j), an HCI is generally an employee who ranks among the highest paid 35% of an employer's employees. For this purpose, certain employees may be excluded from consideration, such as employees who are part of a collective bargaining unit. In addition, the five highest paid officers of the employer are considered HCIs. Applying the regulations to Section 105(h)(5) to Section 101(j), it would appear that the level of compensation would be determined on the basis of the employee's compensation for the current year.

Q6. If an insured employee doesn't qualify under one of the status exceptions, and the employer is the beneficiary under an employer-owned policy, can the death benefit still be received income-tax free under the framework of IRC Section 101(j)?

A6. Generally, no. However, if the insured employee dies while actively at work, or within 12 months from the last day that he or she was employed by the owner of the policy, and the employer has met the notice and consent requirements of IRC Section 101(j), then the death proceeds may be received income tax free. This 'status at death' exception may be of most value in the key employee context where the insured is not a director, an HCE or an HCI at policy issue and the death benefit is not being paid to the insured's family members, or used to purchase an equity interest in the business from the estate or family member of the insured. The 'status at death' exception will be of less value to employers' financing deferred compensation arrangements with life insurance where they plan to hold the policy until the employee's death, whenever that might occur.

Q7. How do the above definitions for HCEs and HCIs interact with the guidelines for determining who is a top-hat employee for ERISA purposes?

A7. The determination as to whether an employee qualifies under the top-hat guidelines for ERISA purposes is separate and distinct from the requirements of IRC Section 101(j). It is important to keep in mind that Section 101(j) has only one primary purpose. Specifically, this purpose is to impose requirements on employers that must be met in order for an employer to get a tax-free death benefit from a life insurance policy it owns. It is purely an income tax matter. Top-hat status for participants of employer benefit plans is necessary to exempt employer benefit plans from certain ERISA requirements. It appears most top-hat employees would meet one of the status exceptions of 101(j) described above. However, that does not mean everyone who meets one of the status exceptions would necessarily qualify as a top-hat employee.

8. Are death benefits from employer-owned policies payable to an insured-employee's heirs eligible for tax-free treatment under 101(j)?

A8. Yes, assuming the notice and consent requirements of IRC 101(j) are met, death benefits payable to the **insured's heirs** such as a family member, a designated personal beneficiary, a trust for the benefit of such people, or the insured's estate, are income tax-free. In addition, life insurance death benefits used to purchase an equity (or capital or profits) interest in the employer from any of these persons, would also qualify if the death proceeds are used to purchase such interest no later than the employer's tax return due date, including extensions. It is worth noting that if any portion of the death benefit is intended for the employer, for instance, as with an endorsement split dollar arrangement, then that portion of the death benefit would need to meet the notice and consent requirements and qualify under one of the insured's status exceptions if the death proceeds are to be income tax-free under Section 101(j). If an exception is not available, the death proceeds are taxable to the employer to the extent they exceed the employer's cost basis.

Q9. How does IRC Section 101(j) define 'employer-owned life insurance contract' and why is this definition important?

A9. An employer-owned life insurance contract is one that is generally owned by a 'person' engaged in a trade or business where the same person, or a related person, is also a direct or indirect beneficiary under the contract. For purposes of this definition, a 'person' may include a corporation (including a sole-owner corporation), partnership, LLC (including a single member LLC), sole proprietorship, or similar business entity. However, a life contract owned by a sole proprietor on his or her own life is not an employer-owned life insurance contract. The insured generally must also be an employee of the 'applicable policyholder' on the day the policy is issued. The purpose of this definition is to cast a wide net with respect to business-owned policies so that as many ownership arrangements as reasonably possible are brought within the scope of this code section. If a life insurance policy is not an 'employer-owned contract', the rules of Section 101(j) appear not to apply.

Q10. How does IRC Section 101(j) define 'applicable policyholder'?

A10. The term 'applicable policyholder' generally refers to the person who owns the life insurance contract or a 'related person'. However, under Q & A 1 of Notice 2009-48, a contract owned by a related person will not be considered employer-owned life insurance unless the related person is engaged in a trade or business. This is an IRS interpretation of confusing statutory language favorable to the taxpayer.

Q11. How does IRC Section 101(j) define 'related person'?

A11. For purposes of Section 101(j), a related person is anyone, with a relationship to the applicable policyholder, who is described in either IRC Sections 267(b) or 707(b)(1). Controlled partnerships as defined in IRC 707(b)(1), and a long list of other relationships, including family members and fiduciary relationships, are identified as being within the meaning of related person.

Q12. Are policies owned by a rabbi trust exempt from the requirements of IRC Section 101(j) because they aren't employer-owned?

A12. The grantor of a grantor trust (including a rabbi trust) is considered the owner of property in the trust for income tax purposes. Therefore, policies owned by a rabbi trust are considered to be owned by the trust grantor and would subject the grantor to the rules and requirements of Section 101(j). Rabbi trusts are often used in conjunction with nonqualified deferred compensation plans to hold employer assets, including life insurance policies, earmarked to pay deferred compensation benefits.

B. Administrative Requirements

Q13. What life policies require notice and consent?

A13. Notice and consent must generally be received for all employer-owned life insurance contracts issued or materially changed after August 17, 2006. See Q & A 23 for details on grandfathering rules.

Q14. What constitutes timely completion of the notice and consent requirements?

A14. In general, the employee must have received written notice and given signed consent prior to a policy being 'issued'. Generally, for purposes of Section 101(j), the issue date is the later of (1) the date of application for coverage, (2) the effective date of coverage, or (3) the "formal" issuance of the contract. In addition, an employer-owned life insurance contract may be treated as a new contract, and thus newly 'issued', by reason of a material increase in the death benefit or other material change in the contract. Presumably, this would mean the notice and consent would need to be reviewed and signed by the employee before the later of the date the adjustment application is signed or the adjustment date of the policy.

The policy must also be issued before the earlier of (1) one year from the date of the notice and consent or (2) termination of the employee's employment.

For an inadvertent failure that meets certain 'good faith' compliance requirements, the IRS will not challenge the notice and consent requirement if the failure is discovered and corrected no later than the due date of the employer's tax return for the year the policy was issued. The inadvertent failure corrective relief does not appear to be available for policies issued where the notice and consent requirements were completely overlooked.

It is important to keep in mind that it is the **employer's responsibility** to maintain the necessary records which show that notice and consent requirements have been complied with. In addition, the employer should document the HCE, HCI or director status of any insured at the time employer-owned life insurance is purchased. Failure to do so may jeopardize the tax-free status of the death benefit.

Q15. What information must be included in the notice and consent form?

A15. The notice must inform the employee that the employer, as policyowner and beneficiary, intends to insure the life of the employee. In addition, Section 101(j) requires that the notice provide the maximum face amount for which the employee could be insured at the time the contract is issued. In Q & A 12 of Notice 2009-48, the IRS provides that such maximum face amount, expressed in dollars or multiple of salary, should be what the employer "reasonably expects to purchase with regard to the employee during the course of the employee's tenure". Our Consent to be Insured form permits the employer to select a maximum face amount and should be completed in a manner consistent with Notice 2009-48. Additional notice and consent is required by the IRS if the aggregate face amount of the employer-owned life insurance contracts with regard to an employee exceeds the amount of which the employee was given notice and to which the employee consented.

Q16. What information must be furnished to the IRS in order to meet the new information return requirements?

A16. Every employer with one or more employer-owned life insurance policy must annually file a completed IRS Form 8925. Information required includes the number of employees of the employer and the number of insured employees of employer-owned policies issued after August 17, 2006. However, an employer is not required to complete Form 8925 for a life policy issued after August 17, 2006, as part of a Section 1035 exchange for a contract issued before August 18, 2006 (unless the new contract has a material increase in death benefit or other material change).

In addition, the form asks for the total amount of employer-owned life insurance coverage in force at the end of the tax year. The form also asks if a valid consent form has been received for each policy and, if not, the number of employees for whom the employer does not have a valid consent.

Q17. How will Principal Life Insurance Company support employers who face these new information-reporting requirements?

A17. Summary Annual Reports on business cases administered by Business Market Administration are sent to the producer to be distributed to the employer. Many of these cases will involve employer-owned life insurance. The information provided on the Summary Annual Report will include the name of the insured and the death benefit provided under each policy. This is required information on the IRS Form 8925. There is a Business Market Administration form which must be completed for a policy to be administered through Business Market Administration. Please make sure that such a form is submitted for your employer-owned life insurance cases. Similar information is provided to the employer for cases sold through Nonqualified Employer Retirement Services – Raleigh.

C. Miscellaneous

Q18. Does IRC Section 101(j) apply to tax-exempt employers?

A18. In some cases (as noted in the instructions to the IRS Form 990-T Exempt Organization Business Income Tax Return), nonprofits may be considered engaged in a trade or business. This 'trade or business' activity may make policies owned by the tax-exempt organization subject to section 101(j). Therefore, we will require a notice and consent for all insureds who are employees or former employees of nonprofits if the policies are owned by the nonprofit.

Q19. In what circumstances may an insured who is not a common law employee be covered under the new rules of IRC Section 101(j)?

A19. The 101(j) definition of "employee" includes directors and Section 414(q) HCEs. Both of these classifications may include individuals who are not considered common law employees. A director is an independent contractor in his or her capacity as a director. Section 414(q) HCEs include former employees if the individual separates from service as a HCE or was a HCE at any time after attaining age 55. In addition, a self-employed individual such as a partner or LLC member who is considered an employee under section 401(c)(1) (qualified plan rules) will be considered an employee for purposes of section 101(j). On the other hand, a life insurance contract that is owned by a sole proprietor on his or her own life is not considered an employer-owned policy life insurance contract.

Q20. Are there other parts of IRC Section 101 that may cause life insurance death proceeds to be taxable?

A20. Yes. The transfer for value rule is still part of Code Section 101. In general, unless a specific exception can be applied to a transaction, when a life insurance policy is transferred to a party in exchange for money or other valuable consideration, that policy's death benefit is taxable as ordinary income to the extent it exceeds the policy's cost basis. Primary exceptions are: (1) transfers to the insured; (2) transfers to a partner,

or to a partnership in which the insured is a partner; (3) transfers to a corporation in which the insured is an officer or stockholder.

Q21. What life insurance sale concepts would be impacted by the new law?

A21. As discussed above, a nonqualified deferred compensation arrangement (including the Select Reward and SERP Select Programs) is often informally funded with employer-owned life insurance and may be impacted by Section 101(j) even if policies are owned by a rabbi trust. In addition, the portion of an endorsement split dollar death benefit paid to the employer may be impacted by Section 101(j) to the extent the return to the employer exceeds the employer's basis in the policy. Additional sales concepts which may be subject to Section 101(j) would include Key Person coverage, Stay Bonus arrangements, Death Benefit Only (DBO) plans, Entity Purchase Buy-Sell funding, and Corporate ESOP Repurchase Liability funding. In addition, Family Limited Partnerships and Family Limited Liability Companies may, in some cases, be considered as engaging in a trade or business thereby subjecting insurance on employees (as previously defined) to Section 101(j).

Q22. What's the effective date of Section 101(j)?

A22. Section 101(j) became effective August 18, 2006, subject to the grandfathering discussed below.

Q23. Does Section 101(j) impact employer-owned life insurance contracts issued prior to August 18, 2006?

A23. Generally no, unless such employer-owned life insurance is materially changed after August 17, 2006. As long as these polices are not materially changed (as discussed below), the employer is exempt from having to comply with the new rules of IRC Section 101(j). Employer-owned life insurance issued prior to August 18, 2006 may be exchanged under IRC Section 1035 and the new policies will retain grandfathered status, as long as such new policies are not materially changed as part of the exchange. A loss of grandfathering status will mean that notice and consent forms will be required before the new policy is issued and an exception based on insured status or beneficiary must be found to avoid taxation of the death benefit (in excess of cost basis). In addition, the employer will be subject to the new recordkeeping and information reporting requirements.

Q24. What does 'materially changed' mean?

A24. Q & A 14 of Notice 2009-48 provides the following list of changes not treated as material changes for purposes of section 101(j): (1) increases in death benefit required under section 7702 of the Code; (2) administrative changes; (3) changes from general to separate accounts (or vice versa); and (4) changes resulting from the exercise of a contractually guaranteed option or right. A 'material increase in the death benefit' is identified as a material change.

Q25. Is the transfer of a policy by an employee to an employer subject to Section 101(j)?

A25. Generally, no. However, a subsequent material change would cause the employer-owned contract to be subject to Section 101(j). Also, the transfer may be subject to the transfer for value rules discussed in Q & A 20 above.

Q26. Why did Congress adopt these changes to the tax code?

A26. In general, Congress was concerned about businesses purchasing life insurance policies on the lives of employees without any specific, legitimate business purpose other than a profit motive. Working with life insurance industry representatives, Congress was supportive of adopting an insurance industry best practices approach to preserving tax-free death benefits in legitimate situations.

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BB10051-02 | 09/2014 | #t140527027z