Advanced Sales

Employer-Owned Life Insurance Rules Under § 101(j)

Technical Bulletin

Life insurance is integral to many business protection strategies, such as key person, buy-sell, and split dollar plans. Businesses who implement plans like these typically expect to receive death benefits free of income taxes. However, death benefits of employer-owned life insurance policies could be subject to taxation if they are not in compliance with § 101(j).

What is § 101(j)?

For any employer-owned life insurance policies issued or materially changed after August 17, 2006, Internal Revenue Code Section 101(j) puts conditions on the tax-free nature of death benefits from employer-owned life insurance policies. Failure to comply with the rules could cause the death benefit to become taxable income to the employer.

The term "employer-owned life insurance contract" means a life insurance contract that:

1. Is owned by an entity engaged in a trade or business,
2. Designates the entity (or a related entity) directly or indirectly as a beneficiary under the contract, and
3. Insures an employee of the entity on the date the contract is issued.

Ask your business owner clients:

Did you know that the death benefits of employer-owned life insurance policies issued or materially changed after August 17, 2006 could be subject to taxation if they are not in compliance with § 101(j)?

What must employers do to comply with § 101(j)?

To qualify for tax-free death benefits, an employer-owned life insurance policy must comply with two basic requirements: (a) Notice and Consent ***and*** (b) Employee Status *or* Ultimate Beneficiary.

Practice Note: The Notice and Consent requirements always apply to employer-owned life insurance, regardless of whether or not the employee status or ultimate beneficiary tests apply.

a. Notice and Consent

The notice and consent requirements are met if, *before the issuance of the policy*, the employee

1. Is notified **in writing** that the entity 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 the coverage may continue after the insured terminates employment; and
3. Is informed in writing that the entity will be a beneficiary of any proceeds paid upon the employee's death.

An employer-owned life insurance contract is treated as "issued" on the later of (1) the date of application for coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. See IRS Notice 2009-48 (A-4).

In some cases, other documents may be used to establish notice and consent. For example, in Private Letter Ruling 201217017, the IRS found that the stockholder agreement in place prior to the issuance of a certain life insurance policy contained certain provisions which, combined with the insureds signing the insurance applications on their lives, met the notice and consent requirements. Despite this ruling, clients should always execute a proper notice and consent form. While the ruling provides backup if things are forgotten, it should not be relied on as a proactive planning tool as not all governing documents will contain the required information.

b. Employee Status *or* Ultimate Beneficiary

1. Employee Status: For death benefits to be tax-free, the insured had to be an employee at any time during the 12-month period before death. Alternatively, the business may retain a policy more than 12 months after the termination of employee status and still receive a tax-free death benefit if at the time the policy was issued, the insured qualified as one of the following:
   i. Director,
   ii. Highly Compensated Employee, which is defined as any employee who was a five percent owner during the year or who had annual compensation in excess of $80,000, or
   iii. Highly Compensated Individual, which is defined to include the five highest paid officers, shareholders owning more than 10% of the business (including the family attribution rules), and the top 35% of employees by compensation (with certain exclusions).
2. Ultimate Beneficiary: To the extent that the death benefit is paid to a member of the insured's family, another individual who is not an affiliate of the business, a trust for the benefit of the foregoing, or the estate of the insured, the death benefits are not subject to income taxes. Likewise, the death benefit is tax-free to the extent it is used to purchase an equity interest in the business from one of these beneficiaries.

What information must be reported to the IRS?

The employer is required to report the following information on 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; and
- That the policyholder has a valid consent for each insured employee (or, if not all such consents are obtained, the number of insured employees for whom such consent was not obtained).

Form 8925 is attached to the employer's federal income tax return and due by the due date of that return.

Remember that time-honored axiom: **"when in doubt, fill it out."**

What are the consequences of not filing Form 8925?

- There is no clear guidance as to the consequences for failing to timely file Form 8925.
- Under § 6723, the employer could face a $50 fine for each instance of a failure to comply with a reporting requirement.
- On the face of the statute, § 101(j) seemingly should not cause the death benefit to become taxable merely due to a failure to file Form 8925. However, clients should consult with their tax advisors for clarity in such situations.

What arrangements could be subject to § 101(j)?

The definition of "employer-owned life insurance policies" outlined above is very broad. The following are some examples of arrangements that might fit this description:

- Key person policies
- Entity purchase buy-sell agreements
- Split dollar arrangements, to the extent that someone other than the ultimate beneficiaries listed in paragraph b.2 above receive a share of the death benefit greater than their total premiums paid into the contract. This might occur in endorsement split dollar arrangements where the employer retains a fixed portion of the death benefit rather than merely the total premiums paid by the employer, or in non-equity collateral assignment arrangements where the employer receives death benefit in excess of premiums paid.
- Family limited partnerships and LLCs
- Deferred compensation and supplemental executive retirement plans (SERPs) informally funded with employer-owned life insurance

Is there a way to fix a situation where notice and consent was not obtained prior to policy issue?

The IRS has provided limited relief if the issue is caught quickly. The service will not challenge a claimed exception from taxation under § 101(j) so long as:

1. The policy owner made a good faith effort to satisfy the notice and consent requirements,
2. The failure to satisfy those requirements was inadvertent,
3. The failure was corrected by the due date of the policy owner's income tax return for the year in which the policy was issued, and
4. The insured employee is still alive and able provide written consent.

In situations where the above relief will not apply, an alternative might be to intentionally cause a "material change." Under IRS Notice 2009-48, a new notice and consent form is required where there is a material increase in the death benefit or other material change. While material changes are not defined, examples of non-material changes include increases in the death benefit due to operation of § 7702, paid-up additions, or performance of the cash value. Other non-material changes include administrative changes, changes back and forth between the general account and separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued. No guidance has been provided as to how large of an increase in the death benefit is required for the change to be considered "material."

What additional resources are available?

IRS Notice 2009-48 provides information on employer-owned life insurance contracts in a question and answer format, and expands on many of the issues discussed herein.

For more information on life insurance planning for businesses, please contact your Crump representative.

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