



BORDEN HAMMAN



Insights

A Comprehensive Guide to
IRS Tax Code 101(j)

This publication has been provided for you by Borden Hamman.

Contents

Overview of IRC §101(j) – Setting the Stage	Page 2
The requirements of IRC §101(j)?	Page 3
Reporting and recordkeeping	Page 3
Failure to comply with form 8925	Page 4
Apply to common situations	Page 4
1035 exchange guidelines	Page 6
Can EOLI / COLI non-compliance be corrected?	Page 6
Sample Notice and Consent Document	Page 7

Employer-owned Life Insurance and Internal Revenue Code Section 101(j)

Many business owners and their professional advisor teams are unaware that employer-owned life insurance (EOLI) or company-owned life insurance (COLI), purchased or materially changed after August 17, 2006, must meet specific guidelines and comply with the IRS "notice and consent" requirements. Failure to do so may result in the life insurance death benefit, less premiums paid, being subject to income tax.

Setting the Stage

Businesses use life insurance for a number of reasons, including to:

- Protect against the death of key employees;
- Accumulate cash to fund future obligations under employee benefit plans; and
- Fund buy-sell agreements.

Life insurance owned by a business is commonly known as company-owned life insurance (COLI). Generally, life insurance is a unique asset in that the inside buildup of cash value is free of income tax, as is the death benefit. As a result, businesses use life insurance as an efficient approach to addressing future obligations.

Creative CFOs realized it was possible for a company to generate positive cash flows from the policies it held for otherwise legitimate business purposes (i.e., key man insurance). Companies then began insuring the lives of not only key employees, but the lives of as many employees as possible. As a result, these arrangements are commonly referred to as "janitor insurance." One particularly egregious arrangement involved Winn-Dixie Stores, Inc., which insured more than 30,000 employees in 1993. In cases like this one, the company would in effect realize a cash windfall on the death of the insured employee. In some cases, the insured was a former employee who had not been an employee of the corporation for years or even decades. A number of these programs were effectively struck down by court cases wherein the court concluded the company did not have an insurable interest in the life of its lower-level employees.

Congress acted in 2006 to discourage such arrangements by targeting the income tax-free nature of the life insurance death benefit. Now, contrary to the general rule that life insurance death benefits are received income tax-free, death benefits paid to employers are generally taxable to the extent they exceed the employer's premium payments, unless certain requirements and exceptions are met for policies that were purchased or changed after August 17, 2006.

What are the requirements of IRC §101(j)?

Internal Revenue Code (IRC) Sections 101(j) and 6039I, enacted on August 17, 2016, as part of the Pension Protection Act (PPA) of 2006, include new rules with respect to the taxation of death benefit proceeds of an EOLI / COLI. IRC §101(j) now subjects the death benefit on EOLI / COLI policies to income taxation to the extent they exceed the employer's basis in the policy, unless (1) a valid exception applies and (2) notice and consent requirements are satisfied.

Valid Exceptions Include:

- The insured is an employee at any time during the 12-month period before his or her death; or is, at the time the contract is issued, a director or a highly-compensated employee; or
- The death benefit is paid to a member of the insured person's family, a beneficiary designated by the insured, a trust for a family member or designated beneficiary, or an insured's estate; or
- The death benefit is used to buy an equity interest in the employer/business from a family member, a designated beneficiary, a trust for a family member or designated beneficiary or an insured's estate.

Notice and Consent

Prior to the issuance of the policy, the employer must notify the employee/proposed insured of the following that the employer intends to insure hit/her life; the maximum amount for which he or she could be insured; and that the employer will be the beneficiary of the death proceeds. Thereafter, the employee must provide written consent to being insured.

What reporting and recordkeeping is required?

Under the new IRC §101(j) rules, if an employer owns life insurance contracts on employees, the employer is required to annual file Form 8925 with the employer's annual return. In addition, the employer is required to maintain records that document compliance with IRC §101(j) and 6039I. Form 8925 requires the employer to provide the IRS with the following information.

- Number of employees at the end of the tax year;
- Number of such employees that are insured under EOLI / COLI contracts at the end of the tax year by policies issued after August 17, 2006.
- Total amount of insurance in force at the end of the tax year under such contracts;
- Name, address and taxpayer identification number of the applicable policyholder(s) and the applicable policyholder's type of business; **and**
- Whether the applicable policyholder obtained valid consent for each insured employee (or, if such consents are not obtained, the number of insured employees for whom such consent was not obtained).

What is the penalty for failure to timely file form 8925?

The IRS has not issued definitive guidance on the penalty, if any, for the failure to timely filed Form 8925. However, failure to file Form 8925 would likely result in a failure to file penalty of \$50 per each instance of failing to comply with a “specified information reporting requirement”. (IRC §6723)

How does IRC §101(j) apply to common situations?

IRC §101(j) applies to all EOLI / COLI policies issued or changed after August 17, 2006. IRC §101(j) applies to a variety of business planning and employee planning arrangements, the more obvious of which include, without limitation, policies used for stock redemption, key-person, non-qualified deferred compensation, endorsement split-dollar and bank-owned life insurance (BOLI). IRC §101(j) may also apply to other situations where the employer is not the policy applicant but may be considered the policy owner, such as collateral assignment split-dollar (economic benefit regime), or where a trust or other entity owns the policy for the benefit of the employer.

IRC §101(j) provides that the term “employer-owned life insurance contract” or “corporate owned life insurance contract” means a life insurance contract that (1) is owned by a person engage in a trade or business, and under which such person (or a related person) is directly or indirectly a beneficiary under the contract, and (2) covers the life of an insured who is an employee of the applicable policyholder on the date the contract is issued.

The term “applicable policyholder” with respect to an EOLI / COLI contract generally means the person who owns the contract. The term “applicable policyholder” also includes any person who bears a relationship specified in IRC §267(b) or §707(b) (1) to the owner of the contract, or who is engaged with the owner of the contract in trades or businesses that are under common control within the meaning of IRC §52(a) or (b).

Buy-Sell Arrangements

- **Redemption** – With a redemption arrangement, the owner of the policy is the employer. As a result, the policy is likely EOLI / COLI and is subject to IRC §101(j) guidelines.
- **Cross-purchase – Corporation** – In a corporate cross-purchase agreement, the shareholders, not the corporation, own the life insurance policy. As a result, it is likely that the policy is not EOLI / COLI and therefore probably not subject to IRC §101(j) guidelines.
- **Cross-purchase – Partnership** – In a partnership cross-purchase agreement, it is not clear whether the partner who owns the policy is considered engaged in the trade or business of the partnership. Therefore, this type of buy-sell arrangement could be considered EOLI / COLI and, if so, would be subject to IRC §101(j) guidelines.

Split Dollar

- **Endorsement Method Split-dollar (Economic Benefit Tax Regime).** In a split-dollar arrangement where the employer is the named owner of the underlying life insurance policy and is a direct beneficiary of the policy, the arrangement fits squarely within the definition of EOLI / COLI and subject to IRC §101(j) guidelines.
- **Equity Collateral Assignment Method Split-dollar (Loan Tax Regime).** In a split-dollar arrangement, subject to the loan tax regime, where the employee is the owner of the underlying life insurance policy, the policy is likely not EOLI / COLI and therefore not subject to IRC §101(j) guidelines.
- **Non-equity Collateral Assignment Method Split-dollar (Economic Benefit Tax Regime).** In a non-equity, collateral assignment split-dollar arrangement, subject to the economic benefit tax regime, where the employee is the owner of the underlying life insurance policy and is entitled only to current life insurance protection under the arrangement, the policy would not appear to be EOLI. However, due to the split-dollar life insurance regulations under IRC §61, the employer is deemed to own the underlying life insurance policy in such an arrangement. As a result, it may be prudent to assume the policy is EOLI/ COLI and subject to IRC §101(j) guidelines.

Section 162 Bonus Plans. In a typical Section 162 Bonus Plan, the employee is the owner of the policy and his/her designated beneficiary receives the entire death benefit. As a result, Section 162 Bonus Plans are likely not considered EOLI / COLI and therefore not subject to IRC §101(j) guidelines.

Qualified Plan Trusts and VEBA Plans. Any life insurance policy held by such a trust is likely not EOLI / COLI and therefore not subject to IRC §101(j) guidelines.

Rabbi Trusts. Because an employer who establishes a Rabbi Trust is generally considered to own any assets held by the trust for income tax purposes, a life insurance policy held by a Rabbi Trust is likely to be considered EOLI / COLI and subject to IRC §101(j) guidelines.

Non-qualified Deferred Compensation Plans. Because the employer owns the life insurance purchased to fund the plans, the policy is considered EOLI / COLI and subject to IRC §101(j) guidelines.

Sole Proprietorship. A life insurance contract that is owned by a sole proprietor on his / her own life is not considered EOLI / COLI and therefore not subject to IRC §101(j) guidelines.

Does IRC §101(j) apply to a 1035 exchange for a contract issued before August 18, 2006?

IRC §101(j) applies to life insurance contracts issued after August 17, 2006 except for a contract issued after that date pursuant to IRC §1035 for a contract issued on or before that date. For this purpose, any material increase in the death benefit or other material change causes the contract to be treated as a new contract and as such would be subject to IRC §101(j) guidelines. A 1035 exchange without an increase in death benefit (or other material change) will not trigger the need for a new notice and consent.

Generally, the following changes are not treated as material changes for purposes of determining whether an existing contract is treated as a new contract for purposes of IRC §101(j).

- Increase in death benefit that occur as a result of either the operation of IRC §7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required);
- Administrative changes;
- Changes from general account to separate account or from separate account to general account; or
- Changes as a result of the exercise of an option or right granted under the contract as originally issued.

Can EOLI / COLI non-compliance be corrected?

Generally, failure to meet the notice and consent requirements under IRC §101(j) will result in death benefit, less premiums paid, being subject to income tax. In Notice 2009-48, the IRS issued guidance that a failure to meet the notice and consent requirements can be corrected in certain limited situations. It should be noted that corrections cannot be made after the insured has died.

Specifically, failure to meet the notice and consent requirements may be remedied if:

1. The employer / policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consent 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 employer / policyholder in which the EOLI / COLI contract was issued.

This material was created by Borden Hamman Insurance Marketing LLC. This material is not intended to provide specific legal, tax or other professional advice. The services of an appropriate professional should be sought regarding individual situations. Borden Hamman Insurance Marketing, LLC nor its subsidiaries or affiliates offer tax or legal advice.

For federal income tax purposes, life insurance death benefits generally pay income tax free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

SAMPLE NOTICE AND CONSENT

NOTICE & CONSENT DOCUMENT FOR: EMPLOYER-OWNED LIFE INSURANCE

NOTICE

You are hereby notified that

_____, the
"EMPLOYER":
intends

1. insure your life for an amount not to exceed \$ _____, **and**
2. will be the beneficiary of any policy proceeds payable upon your death, **and**
3. may continue the policy in force after you terminate employment.

CONSENT

I, _____, acknowledge receipt of the NOTICE and I hereby CONSENT to the EMPLOYER purchasing the life insurance described above.

I, _____, CONSENT to the EMPLOYER continuing the life insurance coverage after I am no longer employed by the EMPLOYER.

Employee Name (Please Print)

Employee Signature

Date

This is a sample form which may be given to an attorney as a reference to create a compliance Notice and Consent form. This page is comprised only of sample language and does not constitute a legal document of compliance with IRC §101(j)