A Comprehensive Guide to IRS Tax Code §101(j)

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Employer Owned Life Insurance & Internal Revenue Code, §101(j)

Many business owners and their professional advisor teams may be unaware that employer owned life insurance purchased or materially changed after August 17, 2006 must comply with the IRS Notice and Consent requirements. Failure to do so may result in the life insurance death benefit, less the premiums paid, being subject to income tax.

Background

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

- Protection against the death of key employees
- Cash accumulation to fund future obligations under employee benefit plans
- Funding 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, the business use of life insurance is an efficient approach to addressing future obligations.

Creative CFOs realized that 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 in the employ of the corporation for years or even decades. A number of these programs were effectively struck down by court cases wherein the court concluded that 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 that they exceed the employers’ premium payments, unless certain requirements and exceptions are met for policies that were bought after August 17, 2006, or that have significant changes made after that date.

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

Internal Revenue Code §101(j) and §60391, enacted on August 17, 2006 as part of the Pension Protection Act of 2006, include rules with respect to the taxation of death benefit proceeds of an employer owned life insurance policy. IRC §101(j) now subjects death benefits on employer owned life insurance policies to income taxation, to the extent that they exceed the employer’s basis in the policy unless a valid exception applies, and notice and consent requirements are satisfied.

Valid Exceptions

- 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.
- The death benefit is paid to a member of the insures person’s family, a beneficiary designated by the insured, a trust for a family member or designated beneficiary, or the 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 the 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 his 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 annually 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 §60391.

Form 8925 requires the employer to provide the IRS the following information:

- Number of employees at the end of the tax year
- Number of such employees that are insured under EOLI contracts at the end of the tax year by policies issued after August 17, 2006
- Total amount of insurance inforce at the end of the tax year under such contracts
- Name, address, and taxpayer identification number of the applicable policyholder and the applicable policyholder's type of business
- 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 file Form 8925. However, it appears the failure to file Form 8925 would likely result in a failure to file penalty of $50 for each instance of failing to comply with a "specified information reporting requirement."

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

IRC §101(j) applies to all employer-owned policies issued after August 17, 2006. IRC §101(j) applies to a variety of business planning and employee benefit 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. IRC §101(j) may also apply in 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" means a life insurance contract that is owned by a person engaged in a trade or business, and under which such person (or a related person) is directly or indirectly a beneficiary under the contract, and 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 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) 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 Section 52(a) or (b).

Buy-Sell Arrangements

- **REDEMPTIONS:** With a redemption arrangement, the owner of the policy is the employer. As a result, the policy is likely EOLI.
- **CROSS-PURCHASE CORPORATIONS:** 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.
- **CROSS-PURCHASE PARTNERSHIPS:** In a partnership cross-purchase agreement, it is not clear whether the partner who owns the policy will be considered engaged in the trade or business of the partnership. As a result, it may be prudent to assume the policy is EOLI.

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.
- **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.
- **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.

Section 162 Bonus Plans: In a typical Section 162 Bonus Plan, the employee is the owner of the policy and his or her designated beneficiary receives the entire death benefit. As a result, a 162 bonus plan is likely not EOLI.

Qualified Plan Trusts & VEBA Plans: Any life insurance policy held by such a trust is likely not EOLI.

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 EOLI.

Nonqualified Deferred Compensation Plans: Because the employer owns the life insurance purchased to fund these plans, the policy is EOLI.

Sole Proprietorship: A life insurance contract that is owned by a sole proprietor on his or her own life is not EOLI.

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 a IRC §1035 exchange for a contract issued on or before that date. For this purpose, any material increase in the death benefit of other material change causes the contract to be treated as a new contract and thus subject to IRC §101(j). 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):

- Increases 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
- Changes as a result of the exercise of an option or right granted under the contract as originally issued.

Can EOLI non-compliance be corrected?

Generally, failure to meet the notice and consent requirements under IRC §101(j) will result in the 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:

- 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;
- The failure to satisfy the requirements was inadvertent; and
- 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 contract was issued.

In Notice 2009-48, Question 8, the IRS states the transfer of an existing policy from the employee/insured to the employer is sufficient to meet the notice and consent requirements. As a result, some commentators suggest one solution to remedy noncompliance is to first transfer the policy from the employer to the insured. Thereafter, the insured could transfer the policy to the employer.

For Attorney Use Only

SAMPLE

NOTICE AND CONSENT DOCUMENT FOR EMPLOYER-OWNED LIFE INSURANCE

This is a sample form which may be given to the client's attorney when requested. It is sample language. The attorney must review this form. The attorney must change this form before it is used for any purpose.

NOTICE

You are hereby notified that ____, the "EMPLOYER intends to:

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

Form **8925** (Rev. January 2010) Department of the Treasury Internal Revenue Service (99)	**Report of Employer-Owned Life Insurance Contracts** ▶ Attach to the policyholder's tax return—See instructions.	OMB No. 1545-2089 Attachment Sequence No. **160**

Name(s) shown on return	**Identifying number**
Name of policyholder, if different from above	Identifying number, if different from above
Type of business	

1	Enter the number of employees the policyholder had at the end of the tax year	**1**	
2	Enter the number of employees included on line 1 who were insured at the end of the tax year under the policyholder's employer-owned life insurance contract(s) issued after August 17, 2006. See *Section 1035 exchanges* on page 2 for an exception	**2**	
3	Enter the total amount of employer-owned life insurance in force at the end of the tax year for employees who were insured under the contract(s) specified on line 2	**3**	
4a	Does the policyholder have a valid consent (see instructions) for each employee included on line 2? . . . . ☐ **Yes** ☐ **No**		
b	If "No," enter the number of employees included on line 2 for whom the policyholder does not have a valid consent	**4b**	

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Use Form 8925 to report the number of employees covered by employer-owned life insurance contracts issued after August 17, 2006, and the total amount of employer-owned life insurance in force on those employees at the end of the tax year. Policyholders must also indicate whether a valid consent has been received from each covered employee, and the number of covered employees for which a valid consent has not been received.

See sections 101(j) and 6039I, and Notice 2009-48, 2009-24 I.R.B. 1085, for more information.

Definitions

Employer-owned life insurance contract. For purposes of Form 8925, an insurance contract is an employer-owned life insurance contract if it is owned by a policyholder as defined below, and covers the life of the policyholder's employee(s) on the date the life insurance contract is issued. If you have master contracts, see section 101(j)(3) for additional information.

Policyholder. For purposes of Form 8925 and these instructions, a policyholder is an "applicable policyholder" as defined in section 101(j)(3)(B). Generally, a policyholder is the person who owns the employer-owned life insurance contract, and who is (a) engaged in a trade or business that employs the person insured under the employer-owned life insurance contract and (b) the direct or indirect beneficiary of the employer-owned life insurance contract.

Related person. A related person is considered a policyholder if that person is (a) related to the policyholder (defined earlier) under sections 267(b) or 707(b)(1), or (b) engaged in a trade or business under common control with the policyholder. See sections 52(a) and (b).

Employee. Employee includes an officer, director, or highly compensated employee under section 414(q).

Insured. An individual must be a U.S. citizen or resident to be considered insured under an employer-owned life insurance contract. Both individuals covered by a contract covering the joint lives of two individuals are considered insured.

Notice and consent requirements. To qualify as an employer-owned life insurance contract, the policyholder must meet the notice and consent requirements listed below before the issuance of the contract.

1. Provide written notification to the employee stating the policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued.

The written notification must include a disclosure of the face amount of life insurance, either in dollars or as a multiple of salary, that the policyholder reasonably expects to purchase with regard to the employee during the course of the employee's tenure. Additional notice and consent are required 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. See Q&A-9 and Q&A-12 in Notice 2009-48.

2. Provide written notification to the employee that the policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

3. Receive written consent from the employee. See *Valid consent* under the instructions for line 4a.

Electronic notification and consent. The written notification and consent requirement can be met electronically only if the system for electronic notification and consent meets requirements 1 through 3, above. See Q&A-11 in Notice 2009-48 for more information.

Issue date of contract. Generally, the issue date of a life insurance contract is the date on the policy assigned by the insurance company on or after the date of application. For purposes of meeting the notice and consent requirements, the issue date of the employer-owned life insurance contract is the later of (1) the date of application of coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. See Q&A-4 in Notice 2009-48 for more information.

Who Must File

Generally, every policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006, must file Form 8925 for each tax year the contract(s) is owned.

Section 1035 exchanges. Policyholders are not required to complete Form 8925 for a life insurance contract issued after August 17, 2006, as part of a section 1035 exchange for a contract issued before August 18, 2006. See Q&A-15 in Notice 2009-48 for more information.

However, any material increase in the death benefit or other material change to the contract will cause it to be treated as a new contract and the policyholder is required to file Form 8925. See Q&A-14 in Notice 2009-48 for more information.

For master contracts under section 264(f)(4)(E), the addition of covered lives is treated as a new contract only for the additional covered lives.

See sections 1035 and 264 (f)(4)(E) and Notice 2009-48 for more information.

How To File

Attach Form 8925 to the policyholder's income tax return for each tax year, during which the policyholder has employer-owned life insurance contract(s) in force.

Recordkeeping

You must keep adequate records to support the information reported on Form 8925.

Specific Instructions

Name of Policyholder

Enter the name of the policyholder (defined earlier).

Identifying Number

The identifying number of an individual is a social security number. For all other taxpayers, it is an employer identification number.

Type of Business

Enter the policyholder's trade or business activity.

Line 4a

Valid consent. Before the issuance of the employer-owned life insurance contract, the employee must provide written consent (a) to be insured under the contract and (b) that coverage may continue after the insured terminates employment.

Note. The written consent is not valid unless the related employer-owned life insurance contract is issued (see *Issue date of contract* on page 1) within a year after the consent was executed, or before the employee terminates employment with the trade or business of the applicable policyholder, whichever is earlier. For additional notice and consent requirements that may apply, see item 1 under *Notice and consent requirements* on page 1. Also, see Q&A-9 in Notice 2009-48 for more information.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

Recordkeeping . . . 2 hrs., 23 min.
Learning about the law or the form . . . . 1 hr., 00 min.
Preparing the form . . 1 hr., 4 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.